



Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

INQUIRY INTO HORIZONTAL FISCAL EQUALISATION

MR J COPPEL, Commissioner
MS K CHESTER, Commissioner

TRANSCRIPT OF PROCEEDINGS

**AT FOUR POINTS BY SHERATON 707 WELLINGTON STREET,
PERTH
ON TUESDAY, 14 NOVEMBER 2017 AT 8.30 AM**

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5 **MS CHESTER:** Okay, folks. We might get under way. Good morning,
and welcome to the public hearings of the Productivity Commission Inquiry
into Horizontal Fiscal Equalisation or better known as how we divide up
the GST bucket. My name is Karen Chester. I'm the Deputy Chair of the
Productivity Commission and I'm one of the Commissioners on this
inquiry. I'm joined by my fellow Commissioner, Jonathan Coppel.

10 I'd like to begin by acknowledging the traditional custodians of the land
on which we meet today, the Whadjuk people of the Noongar Nation, and I
would like to pay my respects to elders past and present.

15 Today is our second day of two days of public hearings in Perth. We
will also be holding hearings in Melbourne, Darwin, Adelaide and Hobart
over coming weeks. We will then be working towards completing a final
report, which will be submitted to the Australian Government early next
year.

20 Now before I run through very briefly how we go about conducting our
hearings, I'm obliged by some legislation to say the following, if alarms go,
common sense tells us not to use the lifts and to follow someone who looks
like they're a staff member to an exit and get the hell out of here.

25 Okay. Now turning to the conduct of our hearings. So the purpose of
the PC's hearings are really to allow public scrutiny of our work and to get
feedback on our draft report. It's also to allow scrutiny and feedback on the
submissions of other participants, and we'd encourage you to do so.

30 We like to conduct our hearings in a reasonably informal manner, but
a full transcript is taken by the young gentlemen over here. So, for that
reason, we can't entertain any comments from the floor. But that said, at
the end of today's hearings, if there is somebody who's not registered as a
35 formal participant for today and they have a burning desire to be heard,
we're happy to hear from you briefly later today.

40 Now participants are invited to make some short opening remarks. The
debater's bell goes at five minutes, Treasurer. Keeping these brief would
be appreciated, because this does allow us time to really discuss the matters
raised, open your submissions in greater detail, and our draft report. Now
participants are not required to take an oath, but we just simply ask that you
be truthful.

Most importantly, the transcript from today's hearings will be available on our website as are our participants submissions to the inquiry. Now for any media folk here, and we do have some present, there are some general rules that apply. You should already know what they are. If you don't, please find one of our staff members and they'll make sure that you behave yourselves. Most importantly, there'll be - no video or audio recording of participants is allowed past the opening remarks.

Now I'd like to invite our first participants, and welcome you for joining us here this morning, the West Australian Treasurer and representatives from the Western Australian Government. So before we get underway and before you make your opening remarks, maybe if you could each just identify yourselves for the purposes of the transcript recording, thanks.

MR WATSON: Richard Watson, Executive Director, Department of Treasury.

MR WYATT: Ben Wyatt, the WA Treasurer.

MR COURT: Michael Court, Acting Under-Treasurer, WA Treasury.

MS LAURIE: Kirsty Laurie, Director of Revenue and Inter-Governmental Relations at WA Treasury.

MR SCHERINI: Alex Scherini, Inter-Governmental Relations, WA Treasury.

MS CHESTER: Great. Thank you very much for your pre-draft report submissions, the meetings we've had with your officials, Treasurer, and your post-draft report submission which you got in to us just in time for these hearings, which are much appreciated. But if you'd like to make some brief opening remarks, then we'll get into some questioning.

MR WYATT: I would. Thank you, Deputy Chair, and my remarks will be brief, you'll be pleased to know. Can I also acknowledge the Noongar people, and can I thank the Commission for the opportunity to speak to you today? Can I also note that we have Terry Redman with us this morning? I think he's presenting afterwards. Terry is the member for Warren-Blackwood, a senior member of the National Party, and I think leader of the opposition is presenting later today. Just to highlight I think there is a fairly bipartisan position in respect of the implications of Horizontal Fiscal Equalisation in Western Australia.

My opening statement will focus on three key areas in respect of the policy debate. Firstly, the deficiencies of the current system which, by and large, will have already been well-ventilated. The package of reforms required to address these deficiencies and how we ensure that those reforms
5 are implemented, are perhaps one of the key issues.

The WA Government was encouraged by the Commission's draft report. We are particularly encouraged by the Commission's key message that the current system is broken and needs to be fixed. The Commission
10 importantly recognises the scope of the system to decrease incentives to states to develop their resources and to set optimal tax rates. These findings complement a position paper released by the CGC in September, the Commonwealth Grants Commission in September, which recognised the system is failing to achieve policy neutrality, especially with respect to
15 some minerals, and I think, no doubt, we'll have some questions in that space.

So clearly, there is a growing recognition that the system is broken and needs to be repaired. Given this position has been held by the WA
20 Government for some time by consecutive governments, we do feel a certain degree of vindication in respect of this.

In characterising the current system, however, we think it is important to also note that it fails to meet its equalisation objective in any consistent
25 sort of way. This is despite the system's bewildering level of complexity. Nor does the system meet any reasonable standard of fairness. While "fairness" was not explicitly mentioned in the Commission's Terms of Reference, clearly whether the system meets the community expectation of fairness is relevant to the policy debate and fundamental to broader
30 confidence in the Fiscal Federation that is our country.

Western Australia's strong mining industry is no accident, but the result of a long tradition of pro-development policies. We, Western Australia, have poured billions of dollars into developing our mining sector. Despite
35 this support and the ensuing mining boom, because of the objectives of HFE, our revenue growth over the past decade has been no greater than other states.

At the same time, communities that bore none of the costs or risks associated with facilitating the development of our mining sector, reap these windfall gains. Yet, while our revenues have been equalised with other
40 states, much of the significant expenditure associated with developing our mining sector was not, and certainly as highlighted in our submission, the North West Shelf, I guess, is a classic example in that regard. This isn't
45 fair, nor does it promote equity. As a result, discussions about gains and

losses to states in the context of moving away from equity are meaningless. They assume equity currently exists.

5 So what are we left with? A system that fails to meet its policy objective. A system that cannot ever be made to meet its policy objective, and a system that in nonetheless trying to achieve that objective, does great damage to our economy distorting economic activity, reducing productivity, economic growth and our nation's prosperity. Now, clearly, the system must be reformed.

10 To this end, I support the Commission's recommendations for an HFE objective that aims for reasonable rather than full equalisation. We consider that achieving a reasonable standard is best achieved by equalising to the average State. The chief advantage that equalising to the average has over
15 the other options is that it does the best job of increasing incentives for states to grow their economies.

20 It also does much more to improve budget management by providing longer term stability to GST relativities. Clearly, this would represent significant reform. But, given the significant deficiencies in the system, we should not be aiming for anything less. At the very least, the highly distorting effects of the mining revenue assessment must be addressed. This is the standout failing of the current system, and I regard fixing this as the minimum threshold for meaningful reform. I do note, by way of aside, the
25 Commonwealth Grants Commission appears to be acknowledging this at last as well.

30 It is not reasonable that our efforts to repair our budget are thwarted by such large GST offsets, and that in many cases much of the gains from difficult revenue measures fall through our fingers. I can assure you that, from my relatively short experience as a State Treasurer, the severe equalisation of mining revenues makes it that much harder to achieve optimal policy settings. GST losses have been a factor in recent debates in
35 WA over rate changes for iron ore, gold and stamp duty.

40 Such debates impact on which revenues are increased and which are not. From an efficiency perspective, I would expect that such distortions would be of great concern to the Commission. I guess the best example is that if we were to desire to achieve an extra billion dollars in revenue, you can either increase our iron ore revenue by about \$8 billion or stamp duty by about \$950 million, to give you the idea of the impact of the redistribution process.

45 It is, of course, not enough to simply identify the reforms required. We need to ensure that the right conditions are in place to facilitate those

reforms. This is an area that I encourage the Commission to focus on in its final report, mapping out a practical pathway to reform. I think there are two critical ingredients for achieving reform: credible transition mechanisms; and leadership from the Commonwealth Government.

5

On the former, we have offered some suggestions in our submission that illustrate the sorts of practical transition mechanisms available to help implement reform. These include: a steadily rising relativity floor with the Commonwealth initially funding the cost of the floor; and phasing to an average fiscal capacity by setting relativities at a weighted average of full HFE and average fiscal capacity with the weight for the latter steadily rising.

10

On the role of the Commonwealth Government, it cannot be overstated how important it is that this level of government show genuine leadership. The Commonwealth needs to commit to HFE reform, provide a clear HFE objective to the Commonwealth Grants Commission, and ensure that the Commonwealth Grants Commission achieves it. Where reform is in the national interest it is the national government that must take responsibility to ensure that it is achieved. Requiring all states and territories to consent to reform consigns the HFE system to a future of no reform.

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Ultimately, I'm optimistic that reform can and will be achieved and I believe this because the weight of evidence now shows that the alternative, proceeding full speed ahead with full equalisation despite the economic and fiscal torpedos, is untenable. Common sense must surely prevail. The quicker we implement reform, the sooner we'll have an HFE system that promotes, rather than undermines, national economic growth and prosperity.

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Finally, I say to the Productivity Commission, hold your course against the other states, other states who have been openly hostile since the Commission not just released its draft report but in respect of the request from the Federal Treasurer for you to undertake this, because I think we are – do have an opportunity, regardless of some hostility to the potential reform mechanisms, to actually provide a long term solution to this HFE problem that we have, particularly here in Western Australia.

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Finally by way of an aside, obviously we have made some comments in respect of our submission around the transparency of the Commonwealth Grants Commission, the process by which it goes through its decision-making process, which are in dire need of reform, because ultimately there is a very limited capacity for states to actually feed in advice, views, recommendations to decisions taken by the Commonwealth Grants Commission. But, ultimately, I wish the Commission all the very

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best in its inquiry and I look forward to answering any questions. We look forward to answering any questions that you may have.

5 **MS CHESTER:** Thank you, Treasurer. Thank you for the royal “we” in answering the questions. We might just pause so we can allow the distraction of some of the media folk to make a graceful exit. Thank you. Terrific. Thank you, because Jonathan and I do have some questions we’d like to run through with you. But before - - -

10 **MR WYATT:** Madam Chair, are you happy for general conversation, so to flick around people who may be better placed to answer?

15 **MS CHESTER:** Absolutely. Whoever’s got the content to share shall be heard, and I’ll leave it up to your team to work out how you want to sub in and off there. So before we get into the issue of the HFE system and potential changes, I think it’s fair to say that when we started the work on this inquiry, we kind of realised that the overarching theme was the world of outliers. The three outliers being: how we do HFE, we are a global outlier; what’s happened in WA with the mining royalties, making you
20 fiscally a stronger state and quite a fiscal outlier; and then third indigeneity, probably the most difficult one to grapple with.

If we come to the second outlier, some people might suggest to us that the system was going okay, the relativity rubber band wasn’t being
25 stretched too much back in the early 2000s, and it was only sort of post-2007 that we thought of relativities become very diverse. So some have suggested that this is a blip and thus we don’t need to change the current arrangement. Things will get back to the cosy relativities of past, thus not stretching the system enough, not creating the extent of the disincentives
30 with the equalisation task being so large.

So I guess, one of the issues that Jonathan and I thought would be good to touch on first with you now across in the West is your sense of how long this outlier world is here to stay with respect to the mining royalties for
35 WA? We note from your post-draft submission that you’ve got some forecasts going out well beyond the forward estimates. So it’d be good to get your sense of is this a blip or do you see this being here to stay thus we do need to make architectural change and if so why?

40 **MR WYATT:** I’ll make some broader comments and then I’ll pass to the Under-Treasurer who might make some more specifics. Well, clearly, the – what has happened has been obviously impacted by the price of iron ore during a particular period of time and that has been – had an impact on our revenues, both in terms of price, but now price wise would have to be less

dramatic to have a similar impact as the volumes of iron ore now are so much more dramatic than they were even five, six years ago.

5 The impact is actually much longer term than just a short, say, three or four year period where you have a relativity below 50 – rather 0.5 – simply because the impact on the finances now are probably going to be feeding through three or four terms of government, regardless of who's in power. We have a scenario now where this year, we're looking at an operating deficit of around \$3 billion and that's driven by not just the decline in iron ore, but also the lag factor. We've made comments around how contemporaneous the GST changes should be. That is now expected, at this point, to get to more respectable levels above 0.6 by the end of the forward estimates.

15 In terms of predicting iron ore price, which really is perhaps the more decisive factor on our GST level, we're as good as anybody else at that, but it is not a reliable method. We have good methodology, but it is – doesn't lead to reliable outcomes, and I guess the best example has been the rapid decline in iron ore that, whilst the decline was predicted, at some point the speed of it simply wasn't. Perhaps now that we're moving into a state where the futures market around iron ore is much more mature. We get a better signal around it.

25 But I dare say, whilst the price of iron ore, \$150 a ton, is relatively short term, it may be other commodities that are dominated by a particular State, be it Western Australia or others, that in due course will have a similar outlier problem, if you like. So that's why we're of the view that the architecture does need to be dealt with. But I might pass to Michael, who might make some more specific comments.

30 **MR COURT:** As the Treasurer indicated, you know the volume of iron ore has started to stabilise, but still it's moved from a decade ago of about 240 million tons per annum to 830 million tons of production. The WA budget is highly sensitive to the price of iron ore as well as the exchange rate. So even this year, we've seen the iron ore price move from a high of \$US92 a ton to \$53. So between February and June we've had that over \$US40 a ton volatility, which equates to a \$3 billion impact on the State's revenue.

40 As the Treasurer indicated, we are expected to see our relativity increase to about 0.62 by the end of the forward estimates. We have done some longer term projections, but they're highly sensitive to our assumptions. So I think they've indicated that the relativity may get up to around the 0.86, so well still below per capita share. But obviously it depends on, as I've indicated, the iron ore price is very volatile and our

revenue is very sensitive to that. So the state does have an issue, in terms of budget management, around the volatility of our revenues. The relativity would only increase at a relatively stable rate, whereas our other revenues are bouncing around quite dramatically.

5

MS CHESTER: I guess we understand that it's no longer a quantity and price game, it's more a price game for iron ore based mining royalties going forward, and that there's volatility issues from the budget management perspective. But I guess from our perspective, we're looking at - I guess the question is over what sort of time horizon do you envisage WA, assuming no other dramatic change – structural change to other states and territories being the fiscal outlier, where would iron ore prices need to get for you to go back to not being the fiscal outlier? We're just trying to get a handle on that.

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MR COURT: I'm just getting a bit – yes.

MR WYATT: I'm assuming - - -

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MR WATSON: I might comment on that, if that's all right?

MR WYATT: Yes. Richard's - I'm assuming the long run average, but Richard might - - -

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MR WATSON: So we've got objective recovery of WA's relativity in our forward estimates. That's driven by a couple of things. The first is it's driven by a property cycle in the eastern states that's increasing their transfer duty revenue. It's also driven by, basically, a historical unprecedented down turn in the domestic economy and then the contributing effect of weaker iron ore prices.

30

So what will happen eventually is that the domestic economy will recover. We'll start to experience sort of trend growth in our own source revenues, our taxes, such as transfer duty and payroll tax, and I'll point out to get a sense of how dramatic the downturn in Western Australia has been, payroll tax contracted by, I think, 7.6 per cent in the last financial year, which again is historically unprecedented.

35

We will always have, well at least for the foreseeable future, have a very strong mining base in terms of basic volume, which won't be replicated by other states. So what will happen down the track is our domestic economy will recover, our own source revenues will begin to grow sort of at roughly sort of longer than average rates growth. It'll be comparable to what goes on in other states at the time, and we'll have that large mining base sitting there.

45

Now prices will go up and down because commodity prices do. But we will still have that, I guess, royalty base that other states don't have and it will drive our relatively. So we will continue to have a relativity that is well below other states and well below 100 for the foreseeable future in mining.

MS CHESTER: Okay. So, Michael, when you mentioned getting to around the sort of 80 plus relativity rate, how far out do you forecasts suggest that might be? Given I know that we're dealing with very wide confidence factors because you're dealing with commodity prices.

MR COURT: So we took those assumptions out at 2026, 2027.

MS CHESTER: Okay.

MR COURT: Yes. So some time away.

MR WYATT: Some time.

MS CHESTER: Yes.

MR COURT: But obviously, there's a lot of uncertainty around how those projections, not only in terms of what we assume, but then what happens in other states, as Richard has indicated.

MR WYATT: You'll see that that is important to note because even since the budget, which was only September and the mid-year review that we're dealing with now, our projections even for 2021 have already taken – have changed and blown out to 2026, I think it is, before we projected 0.8.

MS CHESTER: No. But I mean that's really kind of helpful for us from the two – twin perspective of one, the outlier – our second outlier's here to stay for the foreseeable future, and secondly also, it does help us a little bit with how we're going to be looking at the transition path for any changes that we may recommend to the government ultimately, going out beyond sort of three or four years.

I just note for the transcript, I think you've kindly agreed to share those forecasts and numbers, which means you've also been forecasting relativities for other states to be able to have done the numbers that you've done, which is terrific and very helpful. I'm sure our team will spend quite a bit of time unbundling all of those with you. So we don't need to go into those in detail, but just to say thank you and, for and the record, you're on the hook giving them to us.

5 **MR WYATT:** They're very good, and the Treasury has been generally very good at predicting GST across the forward estimates period. This is obviously a bit longer than that. But it just highlights what the outlier has become almost in all. We've become a normal outlier, if you like, as a result of this happening.

MS CHESTER: Yes, and that was the key issue.

10 **MR COPPEL:** But just on that point, you made an observation that it's extremely difficult to forecast royalty income because of the changes in commodity prices. You also mention the payroll had fallen something like 7 per cent the previous year. How does the stability of GST revenues compare with your other own sources of revenue? Is it more stable,
15 notwithstanding how these relativities can move from year to year, compared to payroll taxes or compared to stamp duties?

MR COURT: Well, the relativity is based on sort of your three year average, whereas all of our other revenue items are based on that, you know,
20 the one year. So that provides some stability. The relativity has also taken into account actual data, whereas we're, I guess, payroll tax, transfer duty, royalties, are looking at forecasts of the relevant parameters that go into those forecasts. So payroll, what we're projecting in terms of employment ranges from – so the relativities do have – are based on actual expenditure.
25

They then also depend on the accuracy of what our royalties are going to be over forward estimates, our payroll tax, our transfer duty, and every other revenue item that is in all the other states. So we're dependent upon the forecasts that are prepared by other states to determine those relativities going forward as well.
30

MS LAURIE: So the forecasting for GST is fairly – highly accurate because it is based on sort of some of the old data as well sort of forward looking. But the issue is if you can actually have those, the time lags make it sort of more easier to forecast, but the time lags also mean that those other changes and our other revenue sources are hitting the budget in a harder way. If you didn't have the GST time lags in the same year that you had to make the changes in the iron ore royalties or the payroll tax or the like, GST would respond to that immediately and help offset that, so then the forecasting errors that occur in the other ones wouldn't be nearly as important if the GST didn't have time lags.
35
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MR COURT: Yes. That's the key point. I mean, whilst with your backward data we can generally forecast pretty well, but when you've had –
45 for the 0.34 relativity we had for 17/18, it's still based on data at a time

when iron ore was \$130 a ton which, at the time with payroll taxes declining, all our property taxes are declining and are still expected to decline for at least another 12 months, the slow reaction is what's really exacerbated, as I said, probably in our \$3 billion deficit for this financial year, which will be our biggest, makes that – highlights, I guess, that. When you have that perfect storm of declining own source plus GST, the slow lag is having a particular – so is it stable? I guess, yes, in terms of you can predict it. But is it stable for budget management? Then it hasn't been.

10 **MS CHESTER:** Yes. I think it's fair to say from the submissions and the feedback that we've received, folk are happy with the current averaging provisions when they're not an outlier. But once you become an outlier, then it does become more difficult, thus which lever do we use here? Do we deal with the HFE architecture as dealing with the outlier or do we try to change the averaging arrangements to make things a bit more contemporaneous for you? Although I think at the end of the day we've agreed that the levers we've allocated in our draft report, and let us know if you disagree, is that let's deal with the outlier in terms of the holistic architecture of HFE leaving the averaging and the lag arrangements in place, which I think all the other states and territories are more than comfortable with.

25 **MS LAURIE:** Our submission sort of notes that the proposals that you've put forward would go a long way to helping some of those time lags problems.

MS CHESTER: Okay. All right.

30 **MR COURT:** Sorry, just one other point on the stability though is a small change in some of the parameters that go into the relativity can have a big impact. So one example being the census results where the State's share of population went from 10.8 to 10.5 [per cent] and that had a \$2 billion impact on our GST revenues, so the forward estimates were - - -

35 **MS CHESTER:** Yes.

MR COURT: - - - affected through a – you know, what it meant in terms of the individual assessments that go into determining that forecast.

40 **MS CHESTER:** Okay. Great. Maybe if we turn then to, I guess, what was the other key issue in our draft report, and you touched on it in your opening remarks, Treasurer, and that is what impact does HFE have on incentives? I think historically, when people have looked at the impact of HFE on efficiency, it's been really about interstate migration.

45

We sort of focussed on it a little bit more from the perspective of does it encourage or discourage states from daring greatly and doing the right things with tax reform or undertaking controversial development activity? I guess, we had a couple of questions around this. The first one would be,
5 historically has there been any sort of development activity that hasn't been pursued in Western Australian because of the current HFE arrangements?

MR WYATT: I'll make some broader comments, but this has actually been something that became a particular issue during the last state
10 campaign, and Terry might make some comments around this then shortly. So regardless of sort of the broader conversation around you know amending State Agreement Acts, the National Party had a particular policy of changing the lease rental fee, which is a royalty. So it's a sort of a charge per ton that historically has been in State Agreement Acts. Now that
15 would've, if changed accordingly, resulted in significant short term revenue, but washed through pretty – would, start of year 4, affect the wash through and send off to other states in the nation.

Similarly, we're having a similar conversation at the moment. My
20 budget is predicated upon a gold royalty increase. Now we lose about 60 per cent of our gold royalty, and so some of the public debate has been around "What's the point? What's the point of actually doing this if you're going to transfer 60 per cent to other states?" When your mechanisms are limited as a State Treasurer and they're all in decline, the own source
25 revenue then you - sort of you do have to sort of, you know, consider even the ones that you don't capture.

So historically, it's been a decision that would be perhaps in the last six years, people are much more aware of what's the point of actually capturing
30 that - a revenue return from your mining sector if it's going to be redistributed. I've actually brought with me one of the many letters I sign off to Western Australians suggesting that we might have a better opportunity with the Commonwealth Grants Commission if we abolished royalties and simply sought some sort of iron ore focussed payroll tax. I
35 dare say the Commonwealth Grants Commission would probably look through that in any event. But it gives you an idea of the sort of conversation that we're having more broadly. But in terms of more specific, Michael, you might be the best.

MR COURT: Well, I suppose as the Treasurer said in his opening
40 statements, the state is generally or has been, a pro-development State. So it has been focussed on developing the resource sector and has done so through this unique way in terms of State Agreement Acts. So those State Agreement Acts have been all about trying to provide that certainty for

these projects. They're often in very remote areas. They're complex, large projects.

5 So the state has taken a very pro-development attitude to facilitating the resources sector, providing for land tenure and approvals, streamlined approvals, for those projects. I think what the state has also done is to look at trying to also ensure that there's also a contribution from those projects to the infrastructure and, you know, to help the state manage the impact of those projects. In terms of what it means, I guess, the more direct impact
10 in terms of how, it's more about what it does to the revenue policy settings as opposed to not approving projects because it has a GST impact.

MR WYATT: Can I just – there's just one policy change of late that - and yet it's not a political comment, but the effect of port fees out of Port
15 Hedland's port, not for the juniors but for the – for BHP and more broadly capturing Rio as well and FMG, were frozen. Now it might've good policy rationale for that for encouraging increasing tonnage. We changed that and I've now increased that reasonably significantly. But it just highlights that when you're looking at the iron ore sector, because it's the iron ore sector
20 we're talking about, you have to – you're probably doing – making decisions to capture revenue that won't be re-distributed, but may not be the ideal trade facilitation decision. So that's I guess a more recent example that I could give.

25 **MR COPPEL:** The CGC has put out a paper for its 2020 review which includes the idea of quarantining from the equalisation process, 50 per cent of additional revenues, say for example from an increase in the gold royalty. Do you have any views on that suggestion?

30 **MR WYATT:** Yes, I was very pleased to see that. I mean, I think it's actually the Commonwealth Grants Commission kind of recognising that their rigid defence of the status quo has, perhaps, not been – has had some flaws. Whilst it is going, it only applies on my understanding, or would
35 apply, to any increase beyond the status quo, at least it recognises that a state that has had, for example, pro-development policy for a long period of time, should be rewarded according to the revenue that it creates.

40 Now ultimately, that would only apply if we decided post-2020, I think it is, to increase royalty rates. But again, whilst we have had, and I think it's been a very good approach by State Governments for 40 years, that we've had State Agreement Act approaches to large scale developments, it makes it very difficult to then change anything within it. So it probably is having a broader impact on policy decisions around how you go around
45 creating certainties with that sort of huge capital investment that the private sector undertakes to get resources developed. Michael?

MR COURT: Yes. So look I think the Grants Commission process has had to play catch up to what's happening. So in terms of the expansion of the iron ore sector, the government had to look at, you know, the demand for services and infrastructure provided for that, had to look at the revenue seatings to provide for those services. The option it had was, around iron ore, to increase the iron ore royalty rate on fines.

At the same time, the Grants Commission put out a new mining assessment with the low/high category with, probably, a lack of consultation with the State around that assessment and that led to the State actually losing more of that revenue generated by the increase in the iron ore rate through lower GST and led to the Commonwealth Treasurer having to direct the Grants Commission to treat that iron ore fines in the lower rate. So a catch up methodology.

Similarly, until then we didn't have any recognition of the impact of population on a – you know, the infrastructure requirements driven by our population growth. So there's another methodology change back then to sort of catch up to what was actually happening. That obviously makes it very difficult for governments in terms of the incentive to grow your state when you don't know what the revenue impacts might be from those drivers of growth.

MR WYATT: That's a point we've made in the submission is, and that's really the operation of the Commonwealth Grants Commission, is that this - often you're making decisions with really unknown repercussions because the Commonwealth Grants Commission don't engage with a dialogue of, "Well, if you do that, this is likely to be the position we're going to take", which is infuriating half the time.

MS CHESTER: So if the policy settings were to change such that we moved away from full equalisation to - just assume for now equalisation to the average, the CGC follow through on the 50 per cent discount on royalties for increasing royalty rates from their stand point that there is a perverse disincentive and you're not getting policy neutrality and you're not optimising your royalty rates there. Thirdly, at one of our draft recommendations that the CGC would be required to give states a draft ruling on how they might treat a tax change or a new policy so you've got some certainty when you're going to Cabinet to say, "Here's the pros and the cons".

If those three things were to happen collectively is there anything else that the WA Government may need, from the perspective of any material disincentives that you think you still may face, when it comes to

development activity, royalty rates and tax reform? Sorry, that was a very long way of saying, does that address the issues from the disincentives perspective?

5 **MR WYATT:** Yes. The Under-Treasurer will make some more specific comments, but they would be three very significant outcomes for Western Australia, absolutely all three. Michael, will speak to one or two. But certainly, the third, a draft ruling environment would be very useful, you know, obviously on a confidential basis so you can actually have a dialogue
10 with the Commonwealth Grants Commission. But that would be incredibly useful for states, not just WA, but I dare say all. But in respect of the first of its Commonwealth Grants Commission proposal and an average equalisation would have – would effectively resolve the issues that WA has been raising for a long time now.

15 **MR COPPEL:** Do you need both?

MR WYATT: Michael, do we need - - -

20 **MR COPPEL:** Why is it so important to have both?

MR WYATT: That's a good question.

MS CHESTER: Hang on. Let Michael answer first and we'll come back
25 to your question.

MR COURT: Look, I think in combination, yes, they would be a very positive step forward. Each one in isolation though does have some difficulties, but in combination, yes. We've been putting forward a case for
30 a 50 per cent discount of the mining assessment for some time to recognise that there are additional costs in development of those revenues that aren't taken account into the expenditure side of the assessments.

MS CHESTER: So if equalising to the average does take quite a bit of the mining royalties off the table, I think Jonathan's logic was going where my logic was going as well, do you still need the 50 per cent discount for the
35 royalty rate increase, and if so, why, because we're trying to work out the logic?

40 **MR WYATT:** I guess you would when there's a few rapid expansion, but I'm just trying to – we'd probably need some modelling done on that.

MS LAURIE: I think it's when you - like the proposal you put forward sort of helps states up to a point. But then once they're sort of past that
45 point in their relativity, it doesn't actually hit. So the mining assessment

having some sort of changes to the way that the mining is treated, still creates that better incentive for states in the way that they look at mining development. So, I think, the combination is useful.

5 **MS CHESTER:** Maybe that's something we don't need to get a full answer on today. But we do want to come to a landing on whether there's still a case for that. So if you want to provide us with some additional information or cameos to explain why you still think you need both, that would be helpful.

10

MR WYATT: We will do that. I guess there's a couple of things at play there, where you were just looking at - just regardless of the source, you're just looking at the revenue outcome or versus are you trying to create a mechanism that encourages development of your resources? That's been, hence, we're - as a government and I dare say Terry and Mike Nahan will make a similar point, and I know the CCI did yesterday, is we should be - have policies of - within the HFE objective that encourage development as opposed to encouraging not to develop. But we will provide a cameo to that.

20

MS CHESTER: Just going back to that earlier question though, so when I asked historically had there been any development activity that hadn't been pursued because of the HFE, I think where the answer led to was where there are perverse disincentives around changes to royalty rates. I still haven't heard any evidence of are there any development - you know, material disincentives that have stopped development activities from occurring because of the HFE arrangement?

25

MR WYATT: I think the cost to a private sector developer of the royalty regime is not necessarily going to stop a development if it you know - commercially stacks up. But certainly, it's probably more if the decision is made by government to extract value from that, that starts to have an impact. Hence my reference to the "port fees" as an example and also the conversation we had at the last State election around should we increase the lease rental fee, which Terry Redman will point out to you very shortly, hasn't increased for a long period of time. There's zero value in that for Western Australia. I mean you can do that. You lock in a bunch of spend that by your three year, four, you've got quite a large hole in your budget. Then there's also the other issue of well how certain are State Agreement Acts, which have been the bedrock of WA for a long time. Michael?

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35

40

MR COURT: Look it's always a difficult one to prove because, I mean, projects don't go ahead for a range of reasons. Is it due to, perhaps, the State Government not providing a piece of infrastructure because it can't afford to and you can link that back to our budget and with GST? You

45

5 know, it's very hard to directly prove that a project hasn't gone ahead because of the GST impact. As I said though, the government does promote development and it does it through State Agreements, and it's more about the revenue being able to accommodate the impact from the budget point of view.

10 **MS CHESTER:** Okay. So one other thing that would be helpful, in your post-draft report submission you've given us another very helpful cameo of a perverse disincentive around a revenue neutral tax switch with royalties and, I think, payroll tax from memory. Some of the other examples that you've cited here this morning where you're looking at changing royalty rates or revenue measures and you're obviously being lobbied by folk about what impact that might have on the GST distribution and your relativities.

15 It would be really helpful for us to get that on the record from you post today's meeting, if that's possible, because we were taken to task by some other states for our – and it wasn't a throw away, it was very thoughtful wording that we put in there – that an absence of evidence doesn't mean evidence of absence. So the more that we can point to those in our final
20 report is very helpful.

MR COURT: Yes.

25 **MS CHESTER:** We might then move on to – yes.

MR WYATT: Can I just, Deputy Chair, you raised an issue before about indigeneity that I don't think we've dealt with. Was there a particular point you were going to make, seek some information from us on that?

30 **MS CHESTER:** No. No. I'm happy to make that now, Treasurer. So I think some folk had suggested – so we sort of identified the three outliers that the current system is grappling with, and the third one is really indigeneity. There the issue was, as pointed out by some, that with the way that that affects assessed budgets by the Commonwealth Grants
35 Commission as a disability, what's provided to a state or a territory in terms of fiscal capacity for indigeneity in a dollar sense doesn't match up with what's actually spent.

40 We're living in a world, as you would know and we've done a little bit of work on it around overcoming indigenous disadvantage that, you know, the metrics there aren't improving there in terms of outcomes. Some have suggested taking it out of the HFE equation completely and reverting to a world of tied grants. We kind of struggled with being able to deal with the policy problems there in the confines of our HFE inquiry. But instead,
45 we've suggested in our draft report that there'd need to be some meaningful

reform between accountabilities and responsibilities, Commonwealth and state, when it comes to indigenous policies and programs before you could look at making any changes to the way indigeneity is treating in HFE.

5 So that's kind of where we landed in our draft report. We haven't heard back from many people on that element. Everyone's more focussing on how the GST bucket is divided up across states and territories. So we would welcome any feedback today or later that you've got on, was that the right landing in the draft report or should've we looked at doing something
10 further in the confines of HFE?

MR WYATT: Well, firstly I'll make sure that there's further feedback from Western Australia on that. I guess, just quickly, because ultimately there's some other issues no doubt you want to deal with, the issue would
15 be around, as you pointed out, the correct allocation between the state and the Commonwealth which has been a frustration I guess for a long time, and also the unique history of Western Australia. The homelands, for example, have quite a history of Commonwealth Government making decisions, funding decisions over decades and moving people around
20 country, as have states. But also our, I guess, like the [Northern] Territory's indigeneity, WA is inherently tied up with remoteness as well.

MS CHESTER: Yes.

25 **MR WYATT:** But I'll make sure I deal with that specific issue as a government by way of follow up.

MS CHESTER: That'd be great. Also, Treasurer, it's consistent with an element that hasn't had a lot of attention yet in our five year productivity
30 review paper where we talked about some reforms of Commonwealth/State/Federal financial relations and accountability and responsibilities and we did actually say that indigenous policies and programs should be first cab off the rank in that review area amongst the treasurers. Anyway, but thank you for - - -

35 **MR WYATT:** Thank you. I just wanted to see - - -

MS CHESTER: No. Thank you for raising it because most folk haven't to date. So then if we're turning to the transition path. I think we better get
40 to the transition path, or do you have anything else before then?

MR COPPEL: Can I just get back to a very early comment you made in your opening remarks, that the current system fails to meet the equalisation objective, and also does not meet any reasonable standard of fairness. The
45 objective that's defined at the moment by the CGC is to provide every

jurisdiction with the same fiscal capacity to provide services to its citizens. So if I were acting as the devil's advocate or other jurisdictions, they would say, "Well why is that" - - -

5 **MR WYATT:** And they are all devils, don't worry.

MR COPPEL: "Why is that unfair and" – sorry?

10 **MR WYATT:** They are all devils.

MR COPPEL: "Why is that not meeting a reasonable standard of fairness?" What do you - - -

15 **MR WYATT:** The point I want to make about fairness is that issue around equity, and that is whilst it's not specific in your Terms of Reference, is fairness or confidence in this fiscal federation that we have, is it fundamental to its operation? Now having this, and I say this, so the reason I brought this letter in that I've recently written to a Western Australian, is to highlight that every week I sign off a dozen of these letters. Every
20 Western Australian understands that if you – and this is the kind of conversation we're having – you make the effort to develop and you take the political cost of developing, and often there is significant political cost not just fiscal cost, then you should be rewarded and not penalised for that effort, for those efforts.

25 So the fairness issue now, and I dare say if you were to poll, whether it be a credible poll or just walk down the streets, the faith and confidence in the system, the fairness, would be very, very low. That is a problem for the Commonwealth. That's the point I was trying to make around whilst it's
30 not specific to your Terms of Reference around equity and fairness, it's certainly something that can't be ignored by the State or the Commonwealth Government. This is something that has now been washing through WA for a while and there is great hostility to the Commonwealth Grants Commission, the process and the Federal Government regardless of their
35 political colour around the distribution of what is seen as the efforts of Western Australians. Now just, sorry, the first part of your question was around the full equalisation?

40 **MR COPPEL:** Yes, does not meet the equalisation objective.

MR COURT: Yes. So, I mean the - as we said before the Grants Commission is continually revising its methods, so it's obviously not always fully accurate.

45 **MR WYATT:** And the complexity.

MR COURT: And the complexity. In terms of - - -

5 **MR COPPEL:** We've got a bit of background noise. Can you – I can't hear everything you're saying.

MR COURT: Sure.

10 **MR COPPEL:** It doesn't pick up.

MS CHESTER: Actually we might pause. Can we ask the footy team outside to move somewhere else?

15 **MR COPPEL:** They're right next door.

MS CHESTER: Okay. They're next door. Sorry, we can't move the footy team.

20 **MR COPPEL:** Yes. Okay.

MR COURT: So, I mean, the Grants Commission looks to calculate grants on the basis that each state uses the same effort in raising revenue, but it doesn't take into account what the state's revenue policies are in calculating the revenue base, so. It's the same on the expenditure side where they use discounts and don't assess issues because they don't have the data to accurately do that. So it's not actually achieving full equalisation in that sense.

25 **MS CHESTER:** Yes.

30 **MR WYATT:** Which was the – earlier this year about health.

MR COPPEL: So just one final point on this, is it more linked to the poor understanding of the processes that the CGC uses or an intrinsic inequity in the system? Very few people understand in detail - - -

35 **MR WYATT:** I would've thought - - -

40 **MR SCHERINI:** It's intrinsic. There is intrinsic inequity. There definitely is intrinsic inequity in the system. The revenue assessments are basically equalised on the basis of, you know, what you see is equalised. On the spending side, it's just conservatism everywhere. I mean, in the last review, the 2015 review, you know, we basically – we had concerns about the Grants Commission assessments of wages, remote costs, capital growth

45 pressures, various economic development issues, service pressures relating

to mining employees. We had concerns across the board. In some cases, we had some data to support us. In all cases we had some data to support us. But generally, there wasn't enough data to meet the Grants Commissions standards. So you just get an asymmetric outcome.

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MS LAURIE: There's a lot of gaps in what they look at.

MR SCHERINI: It's quite inequitable, quite inequitable.

10 **MS CHESTER:** I think there's maybe two streams to the inequity, one is when you're trying to have such a degree of precision by seeking the holy grail of full equalisation to the highest state, and you're doing it on a sort of a reactive basis as a starter and policies change across states and territories, you're always going to have that sort of – the inequity I think you're talking
15 about. I guess the inequity that, I think, is more aligned with Jonathan and what the Treasurer are talking about is the concept that we called "unfair equality". That is because people don't understand the system and it's portrayed as "We're not getting our fair share of the GST, i.e. where are relativities reached". That corrodes confidence in the system.

20

MR SCHERINI: Yes.

MS CHESTER: It doesn't mean that the system's done anything that it said it wouldn't do. It's just it's not well understood and it's been stretched
25 too far.

MR WYATT: Well, and I've got to say, I mean there's a reason. I watched the former Treasurer, Troy Buswell, first refer to the Commonwealth Grants Commission as a black box, and I kind of understand what he meant now
30 because it's very much information goes in and something's spat out. As a Treasury you try to get a line of sight on that, particularly around decisions that were – that are made without really any feedback in.

I'm just trying to remember now, I'll provide this by way of
35 supplementary, not long after I became treasurer there was a change in the way that Commonwealth Grants Commission assessed private health data, so the private sector and the private insurance covering health spend. Because of a lack of data to the Commonwealth Grants, because as you said it's a holy grail and it's sort of the never-ending supply of data, they
40 changed their assessment and that resulted in a number of hundreds of millions of dollars over the forward estimates in reduced GST for Western Australia.

I'll provide that by way of supplementary because it's quite interesting
45 because it was very much based around there's not enough data so we'll

take an assumption that penalises WA. But I'll have to provide that by way of supp if I can?

5 **MS CHESTER:** Before we get back to policy directions, just on the data point, because you've raised it at this junction, we did have a draft recommendation say "Open the cupboards on data" in terms of what data the CGC gets from the states, how they crunch the numbers, and so similar to what we do at the PC and what we expect of other statutory agencies. I think in their post-draft report submission, it's kind of like the
10 Commonwealth Grants Commission pointing the finger back at the states and saying, "[it's] States' data and some of them won't let us release it". So can I get you guys on the record saying that you're happy for the data to be released? We'll keep working through the other states to try to get that similar undertaking thus that the CGC will be able to not just release the
15 data but also how they did the calculations, so you've got more line of vision going forward?

MR WYATT: On the record, absolutely. I mean, ultimately the more transparent the process is the better it is, and that's been, as I said, the
20 frustration of consecutive governments around – the lack of transparency around it.

MS CHESTER: Yes. While we're on this issue of equity, and again touching back on the CGC's recent post-draft report submission where they've dared greatly and modelled some other policy changes, the key
25 point that they make is what would be the impact on states if we moved to a world of less than full equalisation? Here, they've looked at equalising to the second highest state. So you might remember in our report we sort of had "Current arrangements with the equalisation task", then "Equalising to the second highest", then "Equalising to the average".
30

In that submission, they say to us that over the longer term and beyond the transition path, it would mean that for most states and territories, apart from yourselves as the outlier, they wouldn't be – they would be precluded
35 from providing public services of an average level. So I don't know if you've had time to digest that and whether you'd have any comments on that because it's - - -

MS LAURIE: The CGC's assumption is that at the moment, the full
40 equalisation process is working, but it's not actually delivering full equalisation at the moment. So the starting point is not accurate. So with the gaps that they've actually got in the system at the moment and some of the things that they don't assess the WA's spending needs on, it's arguable that WA currently doesn't have the ability to fund the average level of
45 services. So the CGC's starting point is that the system works. We know

that it doesn't. So therefore their argument that states won't be able to all have the average level of services doesn't really hold, because WA possibly can't do it at the moment because of the gaps in their system.

5 **MS CHESTER:** I guess the other thing is, and I'm just sort of thinking out aloud here, but they look at – through the lens of, “Well, what's the fiscal capacity that we're affording someone to meet those average level of services?” I guess the counter-factual in an outcome sense would be “Well, what are the states and territories actually spending that money on? Are they actually providing the average level of services, if they're given that fiscal capacity?” Is that something that the WA Government's looked at?

15 **MR SCHERINI:** Well, on the national average basis, the states in aggregate are providing standard of services as, you know – standard of services which the Grants Commission aims - - -

MS CHESTER: Because it's what states do.

20 **MR SCHERINI:** - - - to replicate for each individual state. The question is how successful is the Grants Commission in replicating the national average level of services across the individual states? Western Australia, if you like, I mean, our spending on health is in the order of – you know, it's about \$800 million higher than the Grants Commission would think is necessary to provide an average standard of services.

25 Now, so what's the difference? What's the difference? We've had a look at that. We can identify some policy effects, but it's a large gap that we can't identify the reason for, other than Grants Commission methodology problems. We know there are large Grants Commission methodology problems in the health system.

30 In many respects, the Grants Commission, in some sense, tries. But it's a strange game. They change their method on a whim. You know, as the Treasurer referred to the case of the private sector impact on health. They change the methodology on a whim. Hitting us with a \$200 million a year cut in GST and there's just nothing in the report to justify their approach. In the telepresences [between States and the CGC in the 2015 Review] that were discussing that methodology change they were squirming in their seats. They couldn't - - -

40 **MR WYATT:** I guess, it's a combination of, as you pointed out, I mean, if we were to spend the average I'd be taking what, about \$800 million out of our health spend if I was to spend the averages assumed by the Commonwealth Grants Commission. Whilst as a Treasurer I love that idea, it's just simply unrealistic to expect that we could deliver the current

5 services. This comes back to, I think, a conversation we were having around indigeneity and also remoteness which, effectively, a system that assumes the remoteness kind of expires once you get past really Kalgoorlie, is ludicrous. So that's why there's no way, for example, that the average around - health is always – it's the biggest part of the budget.

10 We spend above average because of the nature of our state. We have a small population spread amongst a huge state. I think the obsession with the data and the assumptions around what State Governments should be spending, by the Commonwealth Grants Commission, are based on their own assumptions around averages. But, of course, then make no comment or feel as though there's no role to play in making decisions around how states also maximise their revenue base.

15 **MS CHESTER:** Yes.

MR WYATT: So it's sort of this kind of – they do one thing but not the other.

20 **MS CHESTER:** Yes.

25 **MR SCHERINI:** The Grants Commission gets trapped sometimes by its methods. It's got a traditional method for identifying remote areas and very remote areas and so on. But when that breaks down, they don't know what to do. In the last review, we provided I thought pretty good evidence that costs in our remote and very remote areas were higher, significantly higher, than costs in other states' remote and very remote areas. Because their methodology is kind of created around the idea of comparability in remote and very remote areas, they're kind of left up the creek without a paddle. 30 They don't really know how to handle it and their general approach is just to dismiss things that don't fit their models. That's the problem, they can't handle extreme - they can't handle extremes.

35 **MS LAURIE:** It's the outlier thing you were talking about before.

MR SCHERINI: Yes, the outlier thing - - -

40 **MS LAURIE:** Where there's outliers, the HFE system doesn't work very well.

MR SCHERINI: It just falters. It falters.

45 **MS CHESTER:** We did hear some colourful examples yesterday of comparing Burnie and Broome and we won't go there again. I'm not spending three and a half hours – three and a half days driving to Broome.

MR WYATT: Between Burnie and Broome.

5 **MS CHESTER:** Let's turn to transition path, if we are looking at perhaps moving away from equalising to less than the highest state. Your post-draft report submission did provide two options around transition paths. Before we make sure – have a bit of a chat about those and make sure that we fully understand them, I guess it would be helpful for us to understand what sort of were the guiding principles that you sort of adopted?

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15 When we kind of think of a transition path, the one that we identified in our post-draft – in our draft report was I guess looking at start date implementation timeframe, pacing, and also making sure that particularly the fiscally weaker states were not materially disadvantaged at least during the transition path. So if you could talk us first through the guiding principles and then we might go through the two options to make sure that we understand what you're suggesting.

20 **MR WYATT:** I'll just makes some comments and pass to Michael who's going to make some comments around this. We've given a couple of options, I guess. I note the CCI have a – gave another one yesterday which is to be frank, look there's – they're all fairly – how do you transition the same? There's different paths we can go. But we've also tried to provide you and the Commonwealth Government with options because we're not
25 naïve. Ultimately, you can't do it overnight - you're just not going to get any Commonwealth Government doing it overnight.

30 So it also needs to recognise, so a - there needs to be a transition. There can't simply be a "Well, look at this one. WA's above 75 – 0.75 and we're all okay", and it's actually - but it's meaningless for Western Australia at the moment. But we've looked at a couple of options and the Commonwealth does need to have a role in this in terms of providing transitional funding.

35 I will say, I guess before I pass to Michael, perhaps one – this is perhaps expressing a frustration of many State Treasurers, is that biggest beneficiary of the mining boom that happened in Western Australia was the Commonwealth Government. It wasn't the WA Government. We lost the wealth that was created through the HFE process and so certainly see that
40 there is a role and an obligation on the Commonwealth to help us get back to a fairer – well, get us back to a – whatever the objective of HFE is going to be, the transition does need to be funded by the Commonwealth and also to bring in those states that will otherwise be and, no doubt, continue to be hostile. Michael?

45

5 **MR COURT:** Yes, so I think we've got two options where we look at equalising to the average fiscal capacity. So we would see that our first option would transition over three years, basically to be using rising relativity floors and as the Treasurer has indicated the Commonwealth would have to put in around about \$2 billion to assist with that transition in relation to the impact on other states.

10 There's a second option which is a longer transition over nine years where we're faced with new relativities starting from 20 per cent weight for the new relativities and Commonwealth assistance provided over five years, which totals 4.7 billion. So under that longer time frame, no state would be worse off in terms of their current forward estimates period.

15 **MS CHESTER:** Yes. Under option one, which is kind of like two years of a floor that the Commonwealth pays, so the other states aren't impacted for those first two years and then we go, am I right to say "cold turkey" to ETA and there's no compensation for the other states?

20 **MS LAURIE:** The first year is 100 per cent Commonwealth funding with the 60 per cent floor. In the following year, it's 50 per cent Commonwealth funding, so it does start to phase in.

MS CHESTER: Okay.

25 **MS LAURIE:** Then by the time of the third year, that's basically yes, going straight to the partial equalisation approach with - - -

30 **MS CHESTER:** So when you say "50 per cent" that means the states that are – so the states are then contributing the other 50 per cent of your floor?

MS LAURIE: Yes. So table 2.2 in our submission outlines the dollar impact for each of the states and the Commonwealth on that.

35 **MS CHESTER:** Okay, cool. All right. And then option 2, the nine year phase in which takes us out to 2026/27 is, effectively, keeping the other states whole for four or five years with the Commonwealth putting in 4.5 billion?

40 **MS LAURIE:** Yes. So the first three years the Commonwealth will be providing the assistance to the other states and also the new process phased in sort of slowly starting at 20 per cent.

MS CHESTER: Yes.

MS LAURIE: And then after the third year, the Commonwealth funding starts to phase out. So it's 60, two-thirds funding for the Commonwealth, then one-third, and by the next year the Commonwealth is no longer funding the other states.

5

MS CHESTER: Okay.

MS LAURIE: So it does mean that the other states don't have any impact over their forward estimates.

10

MS CHESTER: Okay. In terms of winners and losers, clearly the Commonwealth putting the bill up front for the paying of the other states and then all the states where we go to with ETA, I guess the other way of looking at it, and Jonathan and I are conscious that we're heading to the other states after today, is when you look at the winners and losers, WA and New South Wales stand to benefit the most from the move to ETA. So did you give any thought to a co-funding model?

15

MS LAURIE: Effectively, the transition is a co-funding model. So, in effect, like instead of jumping straight to addressing the problem immediately and WA having a benefit of multiple billions of dollars, the proposals we've put for transition have a benefit for WA and New South Wales under the second option, which is a lot smaller than it would be otherwise if we jumped straight to it. So, in effect, this is WA and all the recipients of the beneficiary states co-funding the reform process.

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MS CHESTER: By not doing it immediately?

MS LAURIE: Yes.

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MS CHESTER: I guess I was looking at it a little bit more realistically about a transition path and who's going to foot the transition bill. But at the moment, there is a delay in you getting to ETA, which is quite reasonable, given it is a material change. But it's effectively then the Commonwealth who's tipping in the additional money. You just get to ETA a little more slowly. I guess you could do the transition at a slower pace of getting to ETA and that's to some extent WA is co-funding on a greater basis as is New South Wales. Is that something - - -

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MR COURT: Yes.

MS CHESTER: I mean, because I look at those dollar figures for a Commonwealth Government in the current budget situation that it has.

- 5 **MR COURT:** Yes. So I mean, there are obviously different scenarios on how you want to transition that, depending on how fast and so on. So the Commonwealth, as the Treasurer said, has benefited from the economic development of this state. So the fiscal subsidy that goes to the Commonwealth was outlined in previous submission, the expansion of LNG, so WA is becoming the third largest LNG producer in the world. That revenue will flow through to the Commonwealth through the Petroleum Resource Rent Tax.
- 10 **MS CHESTER:** No, I appreciate all those arguments. We're kind of looking at - - -
- 15 **MR COURT:** Yes. But you're ultimately right, the Commonwealth is being looked to, to fund the transition by and large.
- MR COPPEL:** Supposing they weren't in that position, have you thought through options on how to structure an implementation or a transition?
- 20 **MS LAURIE:** The transition ones that we have chosen did have – like we were closely looking at what the impact would be on the Commonwealth, so we purposely chose some transition options that looked more affordable for the Commonwealth and more practical for them to actually be able to implement.
- 25 **MS CHESTER:** Okay. When you look at the funding source, again I guess it depends on what starting point you have in mind. Most of the states, and indeed if I was in their shoes, I'd be arguing the counter-factual is what I would've otherwise gotten if you hadn't changed anything, thus make others as whole as possible and somebody else pick up the tab and I don't
- 30 want to know about it. If we were to look at the starting point as today, what have you got baked in, in terms of the GST growth rate in the GST pool going forward?
- 35 **MR COURT:** The pool? That's based on the Commonwealth's projections of the pool, which is growing.
- MS CHESTER:** Which is just the forward estimates, where as you go out to 2026/27.
- 40 **MR COURT:** Yes.
- MR SCHERINI:** We just assumed it all continues to grow at a steady rate.
- 45 **MR COURT:** Assumed the long run - - -

MR SCHERINI: Yes.

5 **MR WYATT:** If it's like all the other assumptions around that sort of longer term modelling that I get from Treasury, it's usually based on whatever long run average up to a point has been.

MR COURT: We can provide that exact growth rate for you.

10 **MS CHESTER:** Yes. No, I was just thinking one option, and indeed I've seen it happen in previous incarnations, where you're looking at an ugly zero sum game, you start with a different bench mark and then you look at well if there's a growth baked into the pool, perhaps that growth slice can become a funding mechanism.

15 **MS LAURIE:** We have looked at options like that in the past, in terms of sort of relying on growth in the GST pool to compensate states and the states, you know, in nominal terms just to sort of catch up – it takes a very long time.

20 **MR COURT:** A very long time.

MS LAURIE: And I think the point you sort of made is WA has been paying for a long time, and the time to change is sort of as soon as possible rather than waiting that long to make reform.

25 **MR WYATT:** Yes and it'll be – yes. I dare say that it's unlikely there'll be any change to the pool that broadens the base or increases the rate any time soon.

30 **MS CHESTER:** So I guess just on the point of you feeling like the lottery needs to come your way again, other states will suggest that the current fiscal position for WA, and indeed we had a frank exposition of this in our draft report, suggests that a little bit more generosity and spirit around the transition path may be warranted. On that point, we were frank in our
35 exposition of our historical story, the fiscal management of the WA Government. Is there anything that we had in the draft report that you wanted to take us to task on? Now is the chance because I don't think you touched on that in your post-draft report sub.

40 **MR COURT:** The feature box you had around financial management there, look, you indicated that our relativity projections were quite accurate. I think in '14, '15 our relativity came in at 0.37. We were forecasting 0.34. I think there was some commentary around about the level of expenditure. Expense growth in '14, '15 was two per cent. So we had relativities in the
45 30s. Our expense growth has been in that sort of two to three per cent. So

it's not a high rate of expense growth. There was much larger expense growth previously. But those budgets were put in place on the settings of a reduction of expenditure growth which, in terms of when you look at the actual, was two per cent in '14, '15. So the commentary there around not
5 managing expenditure in that year was, I guess, just putting some context to it.

MR COPPEL: I think we were looking at earlier years.

10 **MS CHESTER:** Yes.

MR COURT: '12, '13.

MR COPPEL: Yes, see we didn't think it was - - -

15

MR COURT: Yes, '12, '13 was 3.7 per cent.

MS CHESTER: No, I think there's one table that I just – I know I now will not be able to lay my hands on, where there were some assumptions made not in the forward estimates, about what would happen to relativities with the change of policy by Canberra and if you compare – here it is. So
20 looking at the forward – the big CapEx and forward expense numbers, under assuming a GST relativity floor and assuming no GST relativity floor. They were kind of the same.

25

MR COURT: Yes, the expenditure was the same. So that was a scenario to show what the revenue impact would be of a 75 per cent floor on the net operating balance and net debt, compared to the two scenarios. So the budget aggregates included expense growth, and that was the same under
30 that scenario.

MS CHESTER: I think others, including ourselves, would look at that and say that effectively there was no change to the CapEx and the forward expense profile, based on any change in – so basically, you were assuming
35 if we did get the relativity floor, this is what the expenses would be and you'd pay down debt. Then the actuals were actually the same in terms of expenses. So that for us was quite problematic from a fiscal management.

MR COURT: The scenario was a – was around the revenue side. Yes.

40

MS CHESTER: I know this ancient history for you, Treasurer, but - - -

MR COURT: It was a scenario based on the revenue side, not expenditure side. So the budget included projections that took into account the current
45 policy that the Grants Commission had around the mining assessment and

produced the budget aggregates based on that current policy setting. I guess, as we said earlier, the Grants Commission's continually playing catch up and changing its methods. So one of - the state was arguing for a 75 per cent relativity floor at the time, so those aggregates showed the – all else being unchanged but there was a change in the policy in terms of the GST distribution what that had in terms of the budget aggregates.

MS CHESTER: Okay. I guess I look at that in a common sense way and think one table assumes no relativity floor and expenses are X. One assumes a relativity floor and expenses are the same. So there was no change in the expenses based on not getting the relativity floor. That's where I kind of struggled and that's where other states and academics have struggled. Anyway, I won't belabour the - - -

MR COURT: Yes.

MR WYATT: And that's ultimately the '12, '13 budget is one I remember well and it's one that has been – I'm not sure whether - - -

MS CHESTER: I think this is the '11, '12 actually.

MR WYATT: '11, '12 is it?

MR COPPEL: Yes.

MR WYATT: I'm not sure whether you were still in the meeting, Chair, when - the last Treasurer's meeting, but it's one that is held against me as a Treasurer by other State Treasurers. But ultimately, be that as it may, the issue around, particularly at the moment, around a GST relativity that still takes into account data that's long since gone, I dare say, any State Treasurer I think – or any reasonable State Treasurer would hopefully appreciate that particular issue that we have.

MS CHESTER: No.

MR WATSON: Can I make a comment about the - - -

MR WYATT: You've got Treasury agitated now, Chair.

MS CHESTER: So I'm only - - -

MR WATSON: I think there's – it's - - -

MS CHESTER: No, no, no. I'm only raising it from the perspective of what's reasonable through the lens of other states and territories when we're

looking at a very material change to the HFE arrangements and we're trying to come up with a transition path that's guided by a broader lens of fairness, knowing that history.

5 **MR WATSON:** Well none of those folks have had to cope with the volatility that Western Australia has had to face. So their criticisms do not have – they're not based around a counterfactual of what good budget management might've looked like. You know, it's actually quite a cheap criticism on their part. If they'd had the same volatility, what would their
10 financial outcomes have looked like, assuming that they managed their budget well?

MR WYATT: Which is the point I made earlier on is that trying to take the conversation out of, you know, the obvious political points that are made
15 by both sides into a Productivity Commission review is something that we're very keen to get to. I'm hoping, and I've said this publicly both to my Federal colleagues and to other State Treasurers, to at least let the process have its run, and ultimately I think defending what has clearly become a mechanism that has gotten so – become so overly complicated
20 because no one's been willing to actually address the fundamental principle or the fundamental objective of HFE. So it's become so incredibly complicated that no one really understands it, including the people sitting at this table as we try and get our head around it all. But there would be, I think, nothing to fear from other states if we can get a transition plan that
25 the Commonwealth subscribes to.

MS CHESTER: Yes. No. We're very appreciative of the political environment within which this inquiry is being conducted, but also very aware that transitions paths do have to work within a political economy
30 which does mean that history is still important. Okay. Well, I think that covers off transition path. We've done data.

 A couple of other questions. So we just wanted to make sure we understood in your post-draft report submission, the logic around not
35 moving towards an efficient cost benchmark, which was kind of into the future for us, in terms of you can't do it in the now but it would be something good to aspire to, especially if the CGC begins to work in a world which is – if it's less than full equalisation, you don't need to have the holy grail of the calculations and the world of false position.
40

MR SCHERINI: I mean, we are quite open to simplification in the spending area and particularly simplification that more clearly identifies the disabilities that the states face. It wasn't totally clear to me what you were aiming to achieve with the cost benchmark, whether you were talking about
45 simplification or whether you were talking about depressing the cost

differentials amongst states, and whether you were planning to apply that to costs as opposed to demands.

5 But the general point we have is that, at the moment, the Grants Commission's assessments are highly asymmetrical and the spending assessments are far more conservatively done than the revenue assessments. That's the fundamental base point from our way of thinking. So, you know, if you want to start – I'm not – as I said, I wasn't quite sure what you were trying to do with the cross benchmark. But if the idea is to
10 try and depress differentials between states, I would say to you that there's already a lot of conservatism built into the spending side. There's no conservatisms built into the revenue side. So you would be basically deepening the asymmetry between the two sides and yielding an even more inequitable outcome.

15 **MS CHESTER:** So I guess the outliers driven by the revenue side and, if we move away from equalising to less than the highest, we deal with your first issue.

20 On the second issue, given the complexity including on the expenditure side and it's based on what states do, moving to an efficient cost bench mark – and indeed, I think we intimated this in our earlier report on natural disaster funding – would be, say with a lot of the health costs at the moment, we know what some efficient pricing – efficient costs are. So instead of
25 saying, "Here's an average based on what states do", you can point to "Well, here's an efficient cost bench mark, so therefore we're going to say that that's how well inform the assessed expenditure side of the equation".

30 Anyway, we don't need to belabour the point today. It was just more I didn't understand the logic. Now I understand your asymmetry point which I think is sort of separate to where we're trying to go longer term on the efficient cost bench marks.

35 **MR SCHERINI:** Yes. Well, if you talking about using national health prices, national efficient health prices, I mean there is debate about how well those national efficient prices are capturing things like remoteness. It's a debate that we will have with the Grants Commission. But this is not a perfect – the national efficient prices for health aren't – that's not a perfect science at the moment. You know, if you look at the remoteness allowances
40 in them, they're not particularly large and the question is why aren't they? You know, you have to look into all the data issues and all the econometrics and complex econometrics that's involved and stuff like that. It's pretty experimental stuff.

45 **MS LAURIE:** We can follow up some of that stuff here sort of.

MR COURT: Yes.

MR SCHERINI: Yes.

5

MR COURT: I mean – and I mean - - -

MS LAURIE: But I'm just conscious of time, but if the – yes.

10 **MS CHESTER:** Yes. And we're only doing it from a broad looking
perspective. We think if we deal with the taking pressure off on the outlier
on the revenue side through changing the equalisation arrangements, it's
then well what can we do in a future sense to reform the expenditure side
so it's not as highly complex as it is today. Anyway, I think we've covered
15 all the questions that we wanted to cover. But now that you've all had a
chance, this is the – is there anything else that you wanted to say or any
questions you have of us, she says bravely and perhaps foolishly?

MR COURT: I think just going back to your question around evidence of
20 projects not going ahead, I mean the GST distribution doesn't assess each
individual project itself. It's a broader assessment. There are many requests
for expenditure that would help resource sector projects that come to
government and can't be provided for a range of reasons including
affordability. So I guess I just wanted to add that point to it as well. There
25 would be mining companies like – say, a road that benefits their projects
but not others. The government may not provide it in the time available due
to affordability constraints. Obviously, the GST is one of those issues in
the affordability.

30 **MS CHESTER:** Yes. Look, we appreciate it's very difficult to unbundle
these things, like I think some of the tangible examples that you and the
Treasurer gave about where people have lobbied you or you've taken into
account in Cabinet discussions what would the implications be for the GST
relativities, that's really helpful for us to get a handle on. I'm very
35 conscious we've gone way over time, which means that this has been a very
helpful session for us and we do appreciate it's been a frank exchange this
morning. So we thank you very much.

MR WYATT: Thank you. Good luck.

40

MR WATSON: Thank you.

MR COPPEL: Thank you.

45 **MS CHESTER:** Thank you.

MR WYATT: Thank you. Much appreciated. All the best with the other states. Lucky you.

5 **MS CHESTER:** We're getting fitted up with the asbestos suits now. See you. Okay, folks, we might resume.

MR REDMAN: Morning, Jonathan. Terry Redman to see you.

10 **MS CHESTER:** Hey, Terry, nice to meet you. Thanks for coming.

MR COPPEL: Yes.

15 **MS CHESTER:** Have you got someone – no, it's just you this morning, Terry?

MR REDMAN: Yes.

MS CHESTER: Yes, cool.

20 **MR REDMAN:** I'm not (indistinct).

MS CHESTER: Okay. No, no, that's all good. Take a seat. Make yourself comfortable and grab yourself a drink.

25 **MR REDMAN:** Bear in mind, I haven't got the benefit of a big stack of Treasury people sitting behind me.

MS CHESTER: And don't take it personally that half the room has vacated, because we never do.

30 **MR REDMAN:** No, no. They'll be chasing the Treasurer. Yes.

MS CHESTER: All righty, folks. Well, we'll get back under way and I'd like to welcome the Parliamentary National Party of Western Australia represented by Terry Redman. Terry, if you could – thank you, and welcome. If you could just state your name and who you represent, just for the purposes of the transcript recording, and then if you'd like to make some brief opening remarks and then we'll get underway.

40 **MR REDMAN:** Thank you. Terry Redman, Member for Warren-Blackwood, Treasury spokesman for the Parliamentary National Party, Western Australia.

MS CHESTER: Thank you. Would you like to make some opening remarks?

5 **MR REDMAN:** Yes. Thanks very much. Thanks for the opportunity to present. Can I acknowledge the traditional owners, the Noongar people, and pay my respects to their elders past and present?

10 Obviously five minutes is not very long to go through a number of things, and hopefully a number of these points will get teased out. But I think it's fair to note that if you look at the National Party history, Tony Crook took a stance in 2010, sorry 2011, when he was the Member of O'Connor and put a motion in Parliament, Federal Parliament to have a 75 per cent floor. Of course, everyone's sitting on one side and Tony Crook and Bob Katter on the other.

15 I guess, I'm making the point in saying that not to necessarily pump up National Party views but to say that this issue has been around for a long time and I think the discussions you had earlier on with the Treasurer highlight some of the complexities with that.

20 We argue very strongly that WA is a very unique jurisdiction, a very centralised population, some two million people in Perth and 600,000 outside of Perth. If you include the sort of populated bit down to the south of Perth, it even gets worse than that. Large distances, remoteness, huge challenge, a big remote Aboriginal population, some 274 remote communities in Western Australia. A low, relatively low populations compared to the rest of the nation, therefore any economic shocks are much more pronounced in terms of having to cater for that shift.

30 Of course, we are heavily dependent upon the resource sector and the volatility around that, particularly the movement from construction through to production in the resource sector, more volatile in the oil and gas sector, which I'm told is something like 13 to 1 in terms of personnel. And some 6 to 1 in the iron ore sector.

35 Of course, with those issues, those unique issues for Western Australia, when you have a boom like we've had, there's a pretty significant cost to the state in managing that. Population growth and all the demand drivers that come from that. We've run the commentary in the past that since 2008
40 Western Australia has had nearly an increase of the population of Tasmania. In percentage terms, that's pretty substantial. Therefore the challenges of our smaller population compared to other states make it difficult.

45 Public services costs are in competition with the resources sector. At one stage, we were the highest paying state in terms of paying nurses, police

and teachers. Housing issues, particularly in the regions. The Perth hotel market, much more expensive on the – during the week than it was on the weekends, for example. It tells you how many people are flying in to use that service. Of course, the pretty significant impact on regional centres.

5 The Pilbara Region, interestingly going to the point of how important this is to the nation, pretty soon they'll be responsible for 40 per cent of the nation's exports, only got a population of something like 40,000 people.

10 We have had, in the previous government – I was a part of that, I was a Minister for eight and a-half years in that – a pretty solid regional development agenda. The Royalties for Regions Program was a part of that, and pretty significant investments in that Royalties for Regions Program to a response to the challenges of facilitating what was happening in the resources sector, including other areas of trying to diversify the economy

15 and essential issues like even down to mobile phone service, for example, which fundamentally is a Federal issue but nevertheless was covered by the state.

20 Over that time the state's net debt grew from about 3 billion to 33 billion. Interestingly, we were running commentary with the Treasurer about sort of signals that show the distinction between services of other states. So I would argue that there's pretty substantial debt funding having gone on in Western Australia to maintain the level of services and support the investment to sustain the resource sector growth at that point. It'd be

25 interesting to see how the state would cater for a similar boom if it was to be triggered now in the context of our current budgetary settings as distinct from where the state was back in 2008 and 9.

30 The challenge for government, and we're in the similar situation as the current government, in the absence of GST reform, you've only got a number of – a couple of areas you can focus on. Obviously cutting costs, you know, that will be criticism that other states might level on Western Australia. I would argue there's a range of reasons why, although we tackled that and pushed the public sector pretty hard, there are a number of

35 sort of unique issues to WA that made that challenging.

Chasing new revenue sources, so trying to find a revenue source that didn't have a flow on impact to GST and hence your targets become the people. You're raising power and water charges, you know, so household

40 costs. The Water Corporation, one of the GTEs now, has got a net accrual to government of some \$400 million a year, which is the highest it's ever been. So the government chases those as sort of own source revenues from – you know by increasing charges and getting more efficient in some of those areas.

45

Payroll tax, less impact on the GST clawback, so payroll tax becomes a target. A pretty inefficient tax and not a tax that every – pretty much uniform across government and opposition is the notion of don't like payroll tax. If we can find a way to reform that, that'd be a good thing. But it's clearly a target in this environment. The corporate sector, the Treasurer talked about the challenges of the gold tax. The iron ore, as a source of payroll and I'll come back to that in a second. Of course, the oil and gas sector which largely goes to the Federal Government, despite Western Australia having to wear the costs of sustaining and supporting those developments.

The Nationals took a position to the last election of looking for a new revenue source and considered this special lease rental charge which was in legacy State Agreements that were drafted up in 1964 for – in this case for Rio Tinto and BHP. There's a charge of two shillings and six pence a tonne, which was there that – for the best that we can understand, it was there to pay for nurses and teachers and police to support those regional areas where this development was happening. There was a grace period of 15 years and then it started to be paid. Now it's 25 cents a tonne. That number hasn't changed, effectively, for 50 years.

We looked at increasing that to \$5. The wisdom I believe at the time, it wasn't me, which would've raised \$7.2 billion across the forward estimates, before of course the flow on impact of the GST clawback. So you would've had this sugar hit, if you like, of revenue which would've been a short term measure. We chose to try and offset payroll tax. A pretty significant concession in payroll tax. I guess I make the point that here's a policy challenge of trying to reduce the impact of a tax that's pretty negative, it's choosing to get another source from a sector that, in our view, could afford to pay some more. Yet, with the GST issues that flow over that in time, you're not able to achieve that. The campaign was run pretty solidly against us, "so 90 per cent of that gets clawed back".

It's interesting to see the ambiguity that sits in the Grants Commission's policies on this. Old State Agreements, you have a number of things that sit in there. Obviously, royalty is one of those, the special lease rental is another, and legacy – sorry, long term value adding commitments to build steel mills for example. If we change the royalty it affects the GST. If we change the special lease rental it affects the GST in the same way as the royalty.

I don't know why something that was put in place to fund teachers and nurses to support the growth of those industries should have a clawback in terms of the GST distribution in time. Even if we were to cash that out, three to four billion dollars in a one off cash out, if you sort of take it out

over a very long term, you can get a sugar hit of that up front, but ultimately it does get impacted by GST.

5 Another question to ask is if, as the Treasurer said before, if you chose not to have a royalty and chose to take an infrastructure fund for example, how's that applied in the Commonwealth Grants Commission? Is there a balance between the two where you can support common use infrastructure as well as supporting the resources sector?

10 Also, if you were to cash out a commitment that those companies made when they signed those State Agreements to effectively build steel mills, if you were to cash that out with a one-off payment in either another infrastructure investment, which has happened in the state, some water infrastructure that Rio Tinto paid for to help supply Karratha plus their own use, a couple of hundred million dollars cashed out some of their long term
15 commitments. How's that treated? So you've got ambiguity in terms of the treatment of a number of elements that sit in these old State Agreements. That was a challenge for our policy settings as well as trying to play that out politically.

20 Our recommendations that come through here are working towards a partial equalisation. I don't think anyone dismisses the fact that we're not necessarily looking for equal, but we're looking for a better deal than what we have right now in terms of our payment in relative terms of GST. We
25 think there should be some immediate signals. We'd like to see a floor put in place early, as blunt as that might be, and even if that was temporary to cater for transition. Of course, increasing policy neutrality as suggested by the Commonwealth Grants Commission.

30 In terms of practical outcomes, any adjustment needs to have an impact in the billions, not millions for Western Australia. That's how significant the issue is for the state. A long term fix avoiding some unintended consequences. Obviously, the Commission needs to have an eye to the politics of this, and that was your last discussion with the Treasurer. It'll
35 be the same with us. You've got that challenge of how you put something on the table that has got practical opportunities. As in that Tony Crook vote a number of years ago, there's not the political will necessarily to land something that impacts politically on other states, so therefore there has to be something that manages the sensitivity around that.

40 I would argue that you need to also resist calls that exempting royalty revenue will push states to increase royalties. States should be able to have the right to consider all options on the table if it wants to have any sort of reform in terms of how it takes on its own source revenues. Of course,
45 something that has an incentive both to invest in development, but also an

incentive to move towards tax reform as a strategy to improve the taxation arrangements in Western Australia.

5 I don't think you will see significant differences between the three parties, the Liberals, the Nationals and Labor Party on the GST front. Whilst my presentation here might not be as eloquent as having the Treasury people behind it, it comes from the point of view of being, sitting around the Cabinet table for eight and a-half years and Nationals looking at options to cater for what is front and centre for us, and that's regional
10 Western Australia and the growth and development of that part of Western Australia. Thank you.

MS CHESTER: No, thank you, Terry. They were very helpful, insightful, and tangible opening remarks in terms of examples that you've seen.
15 Maybe if we go to one of the first examples, and the contemporary one that you've spoke about, so this idea of changing the special lease rental and doing a switch with payroll tax in terms of a tax reform change that's being considered. You might've been here earlier on when we talked about the CGC methodology review and their recent report that suggested – has put
20 on the table, the idea of where there is an increase in royalty rates – and I'm assuming that this would be construed as such, if not tell me so – 50 per cent of the increase would be captured by the State Government.

25 So I guess coming back to the question that I posed a little earlier to the Western Australian Government and the Treasurer was, if we were to move towards equalising to less than the highest state, whether that be equalising to the second highest or equalising to the average combined with the GCG proposal for the 50 per cent retention of any increase in royalty rates, are there any existing elements of the HFE arrangements that you see from the
30 experience that you've had over that decade of material disincentives remaining imbedded in the government system with respect to HFE?

MR REDMAN: I would agree strongly with the Treasurer about the assessment of remoteness in Western Australia. I think that's significantly
35 understated, and the challenge in and around that is understated. In fact, added to remoteness is that some of the most disadvantaged people in Western Australia reside in those remote areas. So therefore you add the complexity of the challenge of supporting that. A 50 per cent concession, I think, on the new revenue was what was pushed. I don't know how quickly.
40 I can't predict how quickly that would come back. Treasury would need to run the numbers around that.

45 But I know that the current government runs a \$3 billion deficit now, predicting they'll, hopefully, get into surplus in the fourth year. We had about three budgets that looked exactly like that and every time we came

- back with those budgets, the GST was rebased, both on our – on the Treasury’s incapacity to accurately assess what that might be, but also on rebasing on population as we got into the most recent years. Every time it came back there was this population rebase which kept the relativities low.
- 5 So the return of GST was just pushed out. Very, very difficult. So I’d be looking for all measures to be in place to support the broader based challenge. In fact, I’ve been – we’ve been slightly more aggressive in suggesting a floor would be a very early signal to help in that regard.
- 10 **MS CHESTER:** I guess we see transitioning to, whether it be equalising to the highest or the second highest state is effectively a dynamic floor over time. Indeed, if you look at some of the numbers that we put in our draft report, if we’d been living in a world of ETA or equalising to the second highest state, WA’s relativities wouldn’t have fallen below 87 cents for the
- 15 former and, I think, 79 or 80 cents for the latter. So there is that element of the dynamic floor. So before we get to transition path, are there any other elements of our draft report, Terry, that you wanted to give us any feedback on?
- 20 **MR REDMAN:** To me, the challenge is that I’m not sure it matters what you put down in your report. The political challenge will be a massive one and I’m not sure it will give either the current Prime Minister or, if indeed it’s Bill Shorten after the next Federal election, the cover necessarily to take that forward. So there’s going to have to be a political will there. Whether
- 25 Western Australia carries the political weight to achieve that or not, I don’t know.
- So therefore, I do make the point of having an eye for something that sort of helps transition, even if it’s extra revenue. We’re going to talk about that
- 30 in a second, I guess. But I think that’s almost the most important piece of this, as distinct from what the elements are that’s there. It needs to be something that recognises Western Australia to the tune of billions rather than millions. That’s pretty much the collective assessment of the challenge that Western Australia has to try and meet its service needs. If we were to
- 35 respond to a significant resource sector shock right now, I don’t think the state could do it.
- MS CHESTER:** I guess that opens up the issue of the CGC methodology review as on a slower boat shall we say, (inaudible) the 2020 methodology
- 40 review, to the extent that there could be changes that they think have merit, delaying that to 2020, in effect, exacerbates the starting point that we have with the relativity band at the moment. So that might be something we might need to get some more guidance from the WA Government on. If there were to be a move earlier to some of those proposals that the CGC’s

suggesting that could have an impact, thus allowing a slower transition path, because it'll take some pressure off.

5 **MR REDMAN:** I wouldn't have thought there's anyone in Western Australia that wouldn't support an aggressive transition, but that butts heads with the political realities of trying to get a shift that's actually long term and real for Western Australia. So I think there's a trade off on that front.

10 **MS CHESTER:** I guess what I'm just thinking out loud here now is that to the extent that the methodology review may have what I call pressure release valves in them, waiting until 2020 for them to come into play is an awfully long time. So that's an overlay to any transition path around changing how we do HFE today in a more architectural sense. So you prompted a good thought, so we'll circle back to WA Government on that one.

20 In terms of the transition path itself, I guess the overarching principle for WA is sooner rather than later. But you've rightly pointed out, we have to be feasible about, effectively, arrangements that are going to be acceptable to other states and territories or something that the Treasurer feels that he could take to other states and territories. I don't know if you've had a chance to look at what was proposed by the WA State Government in their submission to us?

25 **MR REDMAN:** Not in detail, no.

MS CHESTER: Okay.

30 **MR REDMAN:** No. I think, you know, the Treasurer made some remarks and I guess ours, with the exception of some sort of early signal with the GST floor, would be - would carry weight on our front. The Federal Government - these were considered and putting in some - you know, some kick-in payments if you like, so actually funding - helping fund the transition would be a pretty good strategy. It's only temporary. You know

35 the scale of that becomes a challenge, and some sort of glide path to get to the longer term structural changes would obviously suit.

40 Having some sort of exemptions on - you know, we considered our special lease rental as to seeking the Federal Government's exemption from any new resource. So whether it's new volume or new mines, whatever it might be, get some exemption from this point. So the pool, effectively, is the same and hopefully another state's not disadvantaged from this point forward. Having some exemptions in there for the short term, I think it's described as "discounts" in some of the commentary that's come through in

45 the reports.

One of the discussion points that I had with the Treasurer across the chamber, not necessarily Nationals position, but it was interesting discussion to say that if you sought to cash out the special lease rental, for example, this historic charge that was there to fund teachers and nurses 50 years ago, which you could say is a piece of history that doesn't apply now. If you sought to have that bit exempted from consideration in the ongoing Grants Commission process, I think it only draws a couple of million – a couple of hundred million dollars a year, so it's not significant in terms of the significant pool of GST funds.

There might be some special arrangements like that, that might assist and give some incentive to Western Australia considering those options. The Treasurer was open to that in discussions across the floor. It's not necessarily a policy position from our party, but those are the sort of things that, you know, might have to be considered that are slightly outside the box in helping with the transition arrangements.

MS CHESTER: Yes. I guess, where we landed in our draft report on sort of – those sort of ad hoc exemptions is not an ideal path from our perspective, because it does then call into account what's in and out, infrastructure grants out of cycle by – the whole political pressure within the HFE system, because it effectively means you've got two relativities. You've got the relativities that the CGC thinks are being followed, the nominal relativities, and then there's the effective relativities through these other ad hoc arrangements or infrastructure grants from Commonwealth to states.

So I guess we're kind of looking at it from the perspective of the CGC feels that there's a change from the policy neutrality or a policy disincentive perspective, like the 50 per cent discount on the royalty rate increases, bringing forward the timing of that might be a pressure valve as opposed to another special deal, for want of a better description.

MR REDMAN: You know this issue of managing transition is probably the biggest and most central issue in this. How open is the Commission to put up some options like that, albeit not – it doesn't make the niceties of the sort of economic assessment, but they are blunt enough to manage or help in that pathway, as long as they're defined and very clear, and maybe even have some boundaries around it and temporary in nature? You're probably going to have some of those choices, or the governments will be looking for some of those choices.

MS CHESTER: Yes. So I think consistent with our Terms of Reference, and indeed commentary that our Treasurer has said publicly, that our final

report will try to address a transition path and indeed it's a large part of the focus of our post-draft report consultation and public hearings and we had a couple of questions around that in our draft report. Indeed, the Commission over the last sort of three to four years has spent a lot more time and energy between draft and final report helping government with transition paths for major policy changes. So that is something that we will be looking at focussing on.

I guess there's two strands to what we need to kind of finalise our thinking around and our evidence base. One is what's a reasonable and principles-based transition path? Secondly, the evidence gaps that we still struggle with, and you might've picked up on this earlier, where we can point to examples of where policy decisions were taken or not taken, when it comes to royalty rates or revenue changes at the State Government, or where they were influenced at the margin because of what the implications would be for GST relativity.

I get a sense from your comments this morning, Terry, that you might be able to share some examples with us, not right here and now, but perhaps following today's public hearings if you could provide us with any other examples that you've been aware of or know of that would help us fill out that part. Because I guess from our perspective, the big question to ask and answer was what's the economic impact of HFE on the Australian economy? This world of disincentives was where we kind of landed. We've got some cameos and we've got some examples but it's limited. For us to get a better sense of the breadth of that impact, would be really helpful.

MR COPPEL: You mentioned the - - -

MR REDMAN: If I can just make one comment? You know, we put a fair bit of effort into looking at State Agreements, and the Treasurer made the comment about the investment signals that would issue if you were to go and break those – largely seen as contracts. We are less sensitised to that as an issue, given that they've been in place for 50 years. So if these same State Agreements are in place in 100 years, at what point do we see any sort of depletion of the settings that were drafted up in a very different environment to what we have here in Western Australian now?

One of the things that changed, and there are points of influence a government can have when either they're extended or renewed or tender arrangements or requests come from the companies, mostly from the companies to change it for a range of reasons, and one of the rules that changed back in the mid-90s – I think, the previous Premier was around the table at the time point – so rather than say if BHP doesn't, you know, build

a steel mill then they're going to shut the whole BHP industry down, they had to go away and find someone else that might want to mine it.

5 Can you imagine that pressure that is on a Minister and/or a government to make a call like that. They looked at putting a cap on the amount of iron ore. So, "You cannot go past this particular cap, it's embedded in some agreements, unless you seek support from the Government". So even then, you know, the pressure on governments to consider or look at one of the - you know, the two most significant companies in Western Australia being
10 BHP and Rio Tinto to have a look at that as options and choices, you know, for considering new revenue sources for the state irrespective of the GST outcome, is very, very difficult. But we believe one of the things that needs to be in play, and I guess the GST doesn't help the cause.

15 So there's certainly decisions, one based on the impact and threat that comes from the companies if you don't support a particular path. The second is the GST implications. So inherently, there are decisions that happen as a consequence of where we sit financially, and the GST implications of some of those decisions in particular.

20 **MR COPPEL:** I've got one very specific point that you mentioned about the lease rental and the original purpose was to fund teachers and nurses. If you can subsequently provide us a bit more information on whether that revenue was actually set aside specifically for that purpose, I think that's
25 sort of an interesting example. It doesn't have to be now, but if you can point us - - -

MR REDMAN: Yes. Now. We've actually struggled to find a lot of information, including going back and reading Hansard of when this stuff
30 was introduced. Very, very difficult and very little commentary on it. That's the best we can come up with. A lot of it's anecdotal talking to people. It's not necessarily written there, but it was, nevertheless a challenge that was there. In the 90s it was put into the Mining Act, so it applies to mining companies that have been mining iron ore for 15 years.
35 So the only ones that pay it now are BHP, Rio Tinto and, I think, Cliffs. FMG starts to pay it in 2023. I don't think it should be in the Mining Act. I don't think it should be a charge that's relevant today, for the reasons that we understand it was there before.

40 I think at one stage, the Treasurer sought advice and, from memory, it was the Bureau of Statistics, which sounds a bit unusual, who - you might correct me if I'm wrong there, to assess who makes the judgment of whether that's a relevant revenue as it applies to GST. It was deemed that it was. We sought to have that assessed, from memory. I wasn't playing a direct
45 role here, the previous Treasurer was - sought to have that assessed to see

if it, perhaps, should've been exempted for the reasons that you just described. If that's the reasons why it was put in place, well why the hell should that apply to recalibrating the GST 50 years later?

5 **MR COPPEL:** Okay. The second point I wanted to make is the options that you characterise as facilitating in the transition of a relativity floor or discounting, they amount to effectively equalising to something less than the strongest state. So the option that we consider in our report, or one of the options, is equalising to the average. They don't inform a transition.
10 What they do is underscore that in this system that we have, any change that moves away from the status quo will have winners and losers. The manner in which to demonstrate how to make that transition is also to be compelling in terms of what would be the benefits of that? One of them is this sense of the system being unfair. The other is the policy incentives. I think, the
15 point that you made about how it can bear on the choice of the tax mix.

But apart from that, it's an incredibly difficult case to make because, just by definition, you're going to have winners and losers. So my question to you is, if you were in the position of trying to justify this to one of the
20 smaller or fiscally weaker states that don't necessarily have resources, what arguments would you use to convince them that it's also in their interest?

MR REDMAN: I think it's relevant. Although it's interesting, it's another point that was made by the Treasurer. It's relevant that Western Australia
25 has moved from a position of having \$3 billion net debt to \$33 billion, or predicted \$33 billion at the end of the last financial year, that there's been a lot of debt funding in order to manage the maintenance of state services and/or support for the growth or the period of boom that happened.

30 The challenge for government is it needs to keep paying public servants to stay in front of kids and in hospitals, otherwise they're going to finish up driving trucks in the mining sector. The government has always got a challenge of trying to wind back from that resource – sorry, the private sector can do that very efficiently and very quickly. The government has a
35 challenge of managing that over time, including the cost of redundancies, and that's what both the last government and this government has on the table. I still think it's been why it's got the challenge of taking out 3000 public servants. That'll be a massive challenge to sort of adjust it. So I think those are very real things that you do that you see that give a measure
40 of that.

The remoteness factors and, as I say, the lack of – you know Ben made the point that I think the Hon Alannah MacTiernan wrote an article in The West Australian some years back when she was a Federal member about
45 that remoteness factor running out after 800 kilometres or whatever the

distance is, comparing that to Tasmania and other states. So I think there are some clear points that can be pointed to in terms of Western Australia's situation. I guess, if there's a lack of data then let's provide the data or find the data.

5

I think, the thing that stood out to me was comparing Queensland to Western Australia. I think the last financial year, I might have the numbers slightly wrong, but I think we were getting \$2 billion a year in GST with a relativity of 34 cents or something. Queensland was getting \$13 billion, a relativity of \$1.12 or thereabouts. So there's a state that doesn't quite have the same – double our population. You know, it's got a level of resource sector up there. But that to me is just in stark contrast. As was highlighted by the Treasurer, the North West Shelf development, which we support and sustain and invest in communities to keep that sort of stuff happening and not getting a skerrick for it.

15

MS CHESTER: So there isn't, maybe, a fourth outlier at times which takes Queensland into the net recipient quadrant and that's natural disasters. What we've seen in the last two budgets is - - -

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MR REDMAN: We chipped into a levy one time, I recall, to help with that.

MS CHESTER: Yes. Rewind the clock three or four years and there was just back to back natural disasters in Queensland. But anyway that's an outlier that we're not going to go to. Jonathan and I have had the joy of an inquiry on that one already. I didn't have any other questions, did you?

25

MR COPPEL: Well, we've got questions that we've been posing to a number of participants, but they're all really focussing on what we need to grapple with, moving from the draft report to the final report, which is this issue of transition. I would make one point that I'd like to get your feedback on, because it's been made several times that WA has received an increase in population in the order of half a million. One of the impacts that's been attributed to HFE, or that you don't want HFE to contribute to, is migration from one jurisdiction to another induced by the stronger level of services or tax competition.

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So our conclusion is that we didn't find any evidence that the HFE system distorted that migration decision. If anything, it's seen as a positive. There's been a boom in the WA that led to an influx of workers. That construction phase is winding down, and we've seen an opposite flow. I was wondering if you have any reaction to that conclusion?

40

5 **MR REDMAN:** I'm in no position to point to anything that suggests that there's any impact on people shifting around states as a product of the different level of servicing. I just know that the impact of a period of time in Western Australia was massive, which flowed – which rippled right down through the supply chain. It wasn't just, you know, mining towns or mining companies or Perth. People who worked in the hospitality area just couldn't get staff. Farmers couldn't get staff to drive machinery. You know there was massive flow on impacts to the tourism sector. You know the price of rents up in Karratha were \$3000 a week. There was a massive short supply of land. We had to invest in getting the pipeline of land availability happening to support that.

15 Of course, this stuff comes at a peak and it turns off really quickly, and you've still got all this stuff in train which you've either got to put a halt on or wind back, or have something that sort of addresses the more longer term challenges. We made some pretty big investments in regional Western Australia, which we don't back away from at all, in an attempt to try and get more people living in areas that are impacted and where those jobs are up there, to get a more de-centralist focus. Don't retreat from that either.

20 Some people criticise that as being one of the causes of our net debt. I don't agree with that at all. The National Party would certainly contest that, that it was important that we do have proactive de-centralist policy in Western Australia and that goes on for a number of terms of government.

25 **MS CHESTER:** Well, look, Terry, thanks very much for appearing and for providing us with your earlier submission. If we could take you up on your kind offer or if you can provide us with any examples of where you know how the HFE arrangements have impacted on those sorts of decisions.

30 **MR REDMAN:** Yes.

MS CHESTER: And the more recent one that you talked about with the lease arrangements, that would be much appreciated.

35 **MR REDMAN:** Thank you.

MS CHESTER: Thank you very much for appearing today.

40 **MR COPPEL:** Thank you.

MS CHESTER: Okay, folks, we're going to take a little five minute break to stretch legs and do whatever else people feel like doing. So we'll resume at 10.30. Thank you.

45

ADJOURNED

[10.24 am]

5 **RESUMED**

[10.30 am]

MS CHESTER: Okay, folks. We might resume. Our next participant joining us is Damien Kelly, individual.

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MR KELLY: Yes.

MS CHESTER: Representing himself. So Damien, thank you for joining us. Just for the purposes of the transcript, if you could just state your name. If you'd like to make some brief opening remarks, that'd be helpful.

15

MR KELLY: Yes. Thank you, Commissioners. Damien Kelly, that's my name. Okay. The GST cover is merely the tip of the iceberg when it comes to Horizontal Fiscal Equalisation. Historically, it's about 10 to 15 per cent of the total on actual transfers from WA to other states. Each year, the WA Treasury estimates the net redistribution across each state that occurs through Commonwealth revenue raising and spending. The data shows that the Federal Government consistently extracts far more revenues from Western Australia than it's spending in or for the benefit of Western Australia.

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In FY16 there was about \$54 billion in Federal revenues derived from Western Australia versus \$32 billion in outlays. The \$22 billion difference is, effectively, a subsidy to other states. That's in one year. It works out to about \$8500 per capita and about \$16,000 per paid worker. Over the last decade it amounts to a total of 170 billion and over 115 billion of that in the last five years alone. To put it into perspective, New South Wales and Victoria contributed \$4.6 billion and \$1.3 billion respectively in FY16. It works out to about \$600 per capita in New South Wales and \$200 in Victoria. The Northern Territory on the other hand received about \$19,000 per capita. So for a family of five, that's basically almost \$100,00 free kick, and that's in one year.

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The burden on WA has been relentless and it's been going on for at least 30 years. It isn't limited to just mining booms and strong commodity prices, it includes major commodities downturns in this period. If you look at chart 3 – sorry, chart – the chart on the first page of my submission, the data – it's basically got the, Western Australia's net fiscal subsidy to other states in the blue bars, and the index of commodity prices being the red line. That's the RBA index of the commodity prices, and it's indexed – sorry,

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it's – these figures are also adjusted for inflation over the past 30 years. I'll come back to the chart later.

5 It brings me to my next point which is page 3 of the draft report.
There's a couple of paragraphs in there. One says, "A key factor behind
this", that's Western Australia's share of the GST, "falling to an
unprecedented low, has been the recent mining boom which had a
particularly strong impact on Western Australia's revenue raising capacity.
10 This saw Western Australia's relativity start falling from the middle of last
decade". Firstly, the mining boom is over. It's unlikely to enter any new
sustained boom for many years, perhaps decades. Even in 2021, WA's GST
relativity is only expected to be 62 per cent. So on GST alone, we still lose
almost 40 per cent of it in 2021, well into this next downturn.

15 But on a much wider scale – measure of Horizontal Fiscal Equalisation,
that is the effective financial transfers between states that result from overall
Federal Government expenditures and revenues, the story is far more
compelling. Even during the last commodities downturn, WA was
consistently one of the largest net – one of the largest net contributors on a
20 per capita basis, and we were never a subsidy recipient in the last 30 years.
So that's in the red period there, the last red period.

Even in FY – in 2003, 2004, after 15 years of sustained low commodity
prices, we were still the largest contributor or subsidiser of other states and
25 we were easily the largest – we were still the largest on a per capita basis.
We never were a recipient during that period and we were about double
New South Wales on a per capita basis, and they were the next largest
contributor.

30 The FY16 figures that I mentioned before are in the next commodities
downturn, which we pretty much just started, there doesn't seem to be any
chance of symmetry in the decades ahead. In other words, you know,
actually – a bit of give or take coming back this way. It almost seems, you
know, little chance of even an annual balance in that time. So clearly, it's
35 driven by much more than mining cycles and commodity cycles and it's
unsustainable. Unsustainable systems eventually break down one way or
the other.

40 So, essentially, all I'm saying is the draft report does not consider the
effective financial transfers between the states that result from overall
Federal Government expenditures and revenues, and it also gives the
somewhat misleading impression that Western Australia has been an
overall net beneficiary of Horizontal Fiscal Equalisation until the middle of
last decade, which is not the case.

45

5 So I ask that you acknowledge this in your report, especially the key points, and either complete or recommend the completion of further robust studies quantifying the financial transfers to and from each state, looking back further in time and decades forward. They are currently unaccounted for, yet arguably more comprehensive and correct measures of the effects of Horizontal Fiscal Equalisation. So I guess the point is, when it comes to Horizontal Fiscal Equalisation, GST is only the tip of the iceberg. Thank you. Cheers.

10 **MS CHESTER:** Thanks very much, Damien. We might just start with your closing remark about HFE as it relates to the GST pool being distributed across states and territories as only being part of the equation of Horizontal Fiscal Equalisation. Indeed, it's something that we go to length to point out in our report and contextualise it in terms of there are many
15 other transfer payments made from the Commonwealth Government to states and territories beyond what's relevant for the HFE. Indeed the assessed budgets that the Commonwealth Grants Commission does is only a percentage of expenses and revenue. So you're right, it's not the whole story and, indeed, we go to some lengths in our report to contextualise it.

20 Turning to the, I think, the key point in your submission too, as in I take it these numbers are numbers that have been developed by the WA Government with respect to net overall fiscal transfers, state, Commonwealth.

25 **MR KELLY:** State to state by the Commonwealth, yes.

MS CHESTER: Yes.

30 **MR KELLY:** Yes.

MS CHESTER: Because I know that some of these numbers don't exist, so therefore the WA Government must've imputed some of them, for example, we don't know how much GST is really raised from the citizens
35 with both feet planted behind WA's borders.

MR KELLY: Yes.

40 **MS CHESTER:** So these aren't sort of Commonwealth Treasury numbers, these are numbers that have been imputed by the State Government, just so people understand the status.

MR KELLY: Yes.

5 **MS CHESTER:** What would be interesting to know, and it comes to the point of part of the reason – one way of viewing revenue is what's derived of effort of the people of a state versus what's a windfall. To some extent people, economists, may argue that what's under the ground, oil and gas in the waters off shore, are a windfall to the people of that state, albeit we do recognise, as does the CGC, that there's effort and endeavour that's required and costs involved in mining and extracting those mineral and energy sources. So when we look at your net fiscal transfer story, Damien, what would those numbers look like if you were to take out oil and gas revenues and mineral based royalties?

15 **MR KELLY:** I couldn't say because I haven't got the detail and those figures. The publicly available WA Treasury figures – wasn't published. So there is a – in the budget some light – sorry, in the budget papers, some light that's shed on that. Where are we? So the actual sole amount for oil and gas revenues, no, but there is – there's taxes and royalties on mineral/petroleum extraction. There's a line on that one. So I guess in the whole scheme of things therefore, so the FY15/16 that was \$567 million is the estimate. Yes.

20 **MS CHESTER:** Yes. It's okay, you don't have to answer. It's not a spot question.

25 **MR KELLY:** Yes.

30 **MS CHESTER:** It's not a spot test. But it's more making the point that, to some extent, that story – those numbers would look quite different if you were to take out what are sort of oil and gas royalties off shore and mining royalties, to the extent that some may construe that they are a sort of a windfall gain to the state, albeit the costs of actually bringing them to the surface and exporting them are borne and recognised in the CGC calculations.

35 **MR KELLY:** Yes. Can I just, just on – I mean, just on that point, I mean, certainly by these figures even if you assume the whole lot, you know the \$567 million, it's actually half a billion dollars out of \$22 billion. So it's not that great a number. In years gone back, like '13, '14, when prices were a lot higher, the number here is like \$1.6 billion. So then it did have more of an effect. But then, you know, back then the numbers were also \$26 billion going to other states as well. I guess I just make that point so, yes.

40 **MS CHESTER:** Yes. I mean, just looking at it intuitively given where the bars go during the period of commodity prices, it would make sense that a lot of that bar is accounted for by commodity based royalties and revenues.

45 Anyway, it was just - - -

MR KELLY: Somewhat, yes.

5 **MS CHESTER:** Yes. We can ask the WA Government if they've cut the numbers that way.

MR KELLY: Yes. Sorry, that was my other point, yes. I guess that's the whole point of saying we need more robust studies to actually shine light on all this as well so, yes.

10 **MS CHESTER:** So I guess our report did say that there is Horizontal Fiscal Equalisation and some indeed describe it as the glue of our fiscal federation. Do you agree that we should have some form of Horizontal Fiscal Equalisation in Australia and if so what form should it take?

15 **MR KELLY:** Some form, yes, but not - what we've got here is almost you know Horizontal Fiscal Marxism really, you know it's bringing everyone to absolutely equal. I mean, just the disincentive effects on that for anything - you know whether you can actually point to - cite specific individual
20 examples is one thing, but you know just the bringing - making everyone absolutely perfect and equal, I don't think - morally, I don't think it's the right thing to do to have perfect equality in that sense, because then it takes away any incentive for individual, in this case, state endeavour as well.

25 You know, I think it's a - in a nation, it's a worthwhile objective. But when it comes to GST redistribution for example, you know there's already other Horizontal Fiscal Equalisation that goes on, like I mentioned with these other figures. I don't think it should be necessarily taking it from one state to pay for another, you know directly from one state's budget and one
30 state's budget to pay for another state's budget. Say, you know, coming out of consolidated revenue or the Federal Government, just the general budget is one thing, but the disincentive effects that it has, certainly on the state which is providing the subsidy is - it then becomes great and at the forefront of the minds of those making the decisions, like just - not just at the business
35 level but also a state level.

There was a gold royalty debate that was - happened just recently in Western Australia. I'm guessing you're probably aware of that. But one of the major factors behind its ultimate defeat was the fact that it's a short term
40 sugar hit, but eventually more than half of the benefit of the additional royalty is going to go to other states. So where the cost is borne in Western Australia, but the benefit of that - the long term benefit of that royalty, you know more than half of it goes to - directly to other states. It's a disincentive, so.

45

MS CHESTER: But I guess if you were to take the logic of what you're presenting, all Commonwealth consolidated revenue is effectively attributable to the endeavour or activity of individuals or an activity in a particular state or territory.

5

MR KELLY: Yes.

MS CHESTER: Which I think probably takes us into the direction of future Commonwealth, State, Federal financial relations, which is another recommendation in our draft report about the whole vertical fiscal imbalance issue.

10

MR KELLY: Absolutely.

MS CHESTER: So I think well, your submission is heading more in that direction, so what do - - -

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MR KELLY: I think addressing vertical fiscal imbalance would help to addressing the issue of horizontal fiscal imbalance in - you know in the context of these overall revenues. It was touted having a state based income tax at one point you know, provided the Federal Government makes space to remove - to reduce tax itself. That is a notable objective, and that would go some way to addressing this.

20

Also I noticed in your draft paper but also there was an appendix or an analysis about accountability in the Federation in the - that was released at the same time as the draft report. It promotes accountability. I guess just from a basic corporate governance management function, accountability and making one responsible for one's own actions and both the risks and rewards of that is - yes, on average it tends to produce better outcomes so, yes.

25

30

MS CHESTER: So then in terms of moving towards longer term, reforming a Commonwealth, State fiscal Federal relations and addressing VFI, what changes would you want to see in terms of tax and responsibilities, given I think not that long ago that there was an idea on the table including the recent Commission of Audit Paper of a couple of years ago of reverting to allowing some income taxing powers to revert to state and territory jurisdictions.

35

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MR KELLY: I was disappointed when that was binned, basically. Those two recommendations were a step in the right direction. There was a green paper on the form of the Federation as well, that was produced which never made it to a white paper. Yes. But that Commission of Audit was particularly good in that respect I thought, so yes.

45

5 Actually, just on the bit before about windfall as well, you mentioned
about you know sort of what's in the ground essentially being a windfall or
a – you know it's like a free kick. It was never part of the deal at Federation
to actually – you know there was never any agreement or otherwise that
those resources would belong to people in the other states. There was never
any – and again this comes down to a basic governance issue and almost a
contractual issue really. There was never anything, that I can see in the
Constitution or in State, Federal Laws, Agreements or anything like that,
10 that actually handed over those – the economic benefit of those directly and
said, “Well, okay, this actually belongs to everyone, not to each state”. You
know, there was a Federation that came and this is the deal.

15 To me, to assume and say that, “Well, that doesn't really matter”. That
you know - that “The resources of Australia belong to all Australians”, that
changes the fundamental nature of that deal. Now that may be something
that we agree to or whatever, but that's – to say that unilaterally without one
side agreeing to it, I just think it lacks moral ethics so.

20 **MS CHESTER:** I think that's when you're signing up to a Federation, a
fiscal Federation, that's what you're signing up for. But I'm not going to
get into a - - -

25 **MR KELLY:** Yes, okay. Yes, yes.

MS CHESTER: I'm not a Constitutional expert and I won't stray into that
territory.

30 **MR KELLY:** Yes, okay.

MS CHESTER: Jonathan, did you have any other - - -

MR COPPEL: You made the point that the mining boom is over.

35 **MR KELLY:** Yes.

40 **MR COPPEL:** Which, if you're just looking through the lens of HFE, you
could then argue that the relativity that WA receives would continue to –
would rise. So I'm wondering, in the context of that statement, whether
you have any views of how WA relativity will evolve going forward?

MR KELLY: Well, like I said, even during the last commodities
downturn, there was still – we were still the largest contributor on a per
capita basis. So I imagine it will return to – the imbalance will be mitigated

and become less imbalanced, but still nevertheless an imbalance and a significant one.

5 **MR COPPEL:** When you refer to the mining boom over, is it the construction phase to ramp up production? That obviously has to come to an end at some point or is it - - -

MR KELLY: That has come to an end, yes.

10 **MR COPPEL:** Are you arguing also that the production levels will fall from their current levels?

15 **MR KELLY:** I doubt production levels will fall significantly. No, no. I mean, certainly not - when it comes to high CapEx type projects, oil and gas, iron ore, whether production levels fall? I would be surprised if they fell significantly, particularly for the large producers that sit in the lower cost quarter. Higher producers at the margins, yes, there'll be some impact there and there already has been impact. But, yes, I'd say on the large producers there would be less impact on the actual production rates so.

20 **MS CHESTER:** So, Damien, obviously this is something, like many West Australians, that you feel quite passionately about. What sort of prompted you to, you know, actually put pen to paper or fingertips to keyboard and make a submission?

25 **MR KELLY:** Yes. I guess I've been looking at this data for years now, probably at least three, maybe four years, and it's just - it's something that I, yes, am obviously passionate about. I guess one of the things that got me thinking about, you know, putting pen to paper a bit more was a mate of mine who's from Perth but he lives in Melbourne now, came back last year and we were having a bit of a chat about you know "There's a mining boom". He's been to places like Dubai and other places around where they've had mining booms and you know you can see the effects of everywhere. There's infrastructure being built, you know you can feel the effects of it and you see it around. There was obviously some effect here but nothing like you would expect on that sort of scale.

35
40 My instinctive response, "When there's \$20 billion plus going out of the state every year you know, that - what would otherwise be money to spend on those sorts of things just isn't there any more". So that, yes, I guess, made me think well most aren't really aware of these figures. They're not - they're hard to - like WA Treasury, they're in the WA Treasury figures. But they're not - you know there's a page and a-half of it, I think, is what it comes down to and there's not much of a publicity around it. I guess in that sense as well, when I see and hear things like -
45

5 saying that WA has been – you know, we’ve been on the teat of the Federation only until the last you know 10 years or so and we’re only whinging now because the GST isn’t going away, I have those figures in the back of my head and then naturally talk, “Well, no actually it’s been going on for 30 years”.

10 Again on the point of a windfall, and you mentioned about – and I’m acknowledging you said there’s some degree of effort and policy that goes into making sure that you know we create an environment that those resources can be extracted. But I mean things like with the North West Shelf, there was a major financial risk that was taken on by the State Government for example back in the 70s to secure a deal to actually get the North West Shelf built. At that stage they were only looking at domestic sales not exports.

15 The State Government had to enter into a substantial take or pay agreement with the developers at that stage, so that they could say, “Okay, yes, there is enough financial certainty here for us to invest the billions of dollars that’s required to develop the North West Shelf”. Had the State Government not assumed that risk and built the Dampier Gas Pipeline and things like that, we may not actually have that today or it might only just be sort of starting to ramp up now so. Yes.

20 **MS CHESTER:** Well, look we thank you for coming today and for being involved in our inquiry. Thank you.

MR KELLY: Thank you.

30 **MS CHESTER:** All right. Now we’ve got a little bit of time. I’m just conscious that our next participant’s not here, although we’re just checking on that. If that’s the case, what we might do is, we normally wait till the end of our proceedings to see if there’s anybody else that would like to be heard. I understand there might be one other person that would like to be heard this morning.

35 **MR DAVIES:** If possible, I’d like to be heard.

40 **MS CHESTER:** Yes. So if they’re not ready, if it’s okay, we might move to you. But if they are ready, we’ll go to them and we’ll come back to you. Is that all right?

MR DAVIES: That’s fine.

45 **MS CHESTER:** All right. Cool. We’ll give - - -

UNIDENTIFIED SPEAKER: They're outside.

MS CHESTER: They are outside? They're being shy. It's very unlike the next participant. Okay.

5 **MR COPPEL:** Well, why don't we go ahead?

MS CHESTER: Why don't you come on up, we'll get started. We're not going to wait. If they're going to be shy - - -

10 **MR DAVIES:** I might be interrupted.

MS CHESTER: No.

15 **MR COPPEL:** No.

MS CHESTER: You can have five, 10 minutes, let's go. No. We're starting, Mary. Yes. Mary, we'll only be five. Yes. Hello.

20 **MR DAVIES:** I'll have more than five, to be honest.

MS CHESTER: Sorry?

MR DAVIES: I have to have more than five minutes, to be honest.

25 **MS CHESTER:** How long do you need?

MR DAVIES: Less than 10.

30 **MS CHESTER:** Less than 10?

MR DAVIES: Yes.

MS CHESTER: Okay. We might do a switcheroo then.

35 **MR DAVIES:** Okay.

MS CHESTER: Is that okay? If you'd like to do 10, we'll do a switcheroo. All right. So I'd like to welcome our next participant, the leader of the opposition from the Parliamentary Liberal Party of Western Australia.

40 **DR NAHAN:** Good morning. How are you?

MS CHESTER: Please join us. Well, thank you. We're enjoying the second day of our hearings here in WA. If you wouldn't mind, just for the purposes of the transcript that's being recorded this morning, just state your name and who you represent?

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DR NAHAN: Mike Nahan, the member for Riverton and the leader of the opposition.

MS CHESTER: Good.

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DR NAHAN: And the former Treasurer of Western Australia.

MS CHESTER: Well, thank you very much for joining us this morning. Would you like to make some opening remarks?

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DR NAHAN: Yes, I would. First, on the Commonwealth Grants Commission process, it's an old institution and has evolved its process over many decades. Its objective is to reallocate grants, now GST payments according to Horizontal Fiscal Equalisation. It also is made to strengthen and make our Federation whole and equitable.

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I think the system is fundamentally flawed both in terms of how it – in terms of the process and also in terms of the extent. These flaws have been augmented over the last 10 years because it was done as if things were normal and the economy, and particularly in Western Australia, was not normal. We went through the biggest boom in history and the system continued as if everything was normal. I will go through that.

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So my argument is that there is excessive equalisation and there was a failure of the Grants Commission to respond to abnormal circumstances. Those exceptional circumstances were many fold, for instance, over the probably 12-year period. Western Australia had 490,000 people, almost the population of Tasmania migrate to it. We had \$600 billion invested in new infrastructure, mainly in the regions but across the state, LNG, mining of all sorts.

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We ran out of people, so that all the government agencies had to open up recruitment offices around the world to recruit police, doctors, nurses, electricians, and so on and so forth. We had, as I said, \$600 billion invested in infrastructure and mining infrastructure, and we had a population of 2.5 million people. We ran out of people. We, of course, brought in people on FIFO. I don't know what it peaked at. I imagine it pushing 100,000 people. We also had the demand for labour was concentrated in a few areas, particularly investment because it was an investment boom. We ran out of people. Wages were high. Costs were high.

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5 It was a classic boom. In fact, I think you measure it, it was the largest economic boom in the nation's history, at least since the gold rush in Victoria in the 1880s. It was concentrated in WA, (indistinct) – Queensland had a bit, but nothing of the same scale. It was largely up in the Pilbara. Very exceptional circumstances, both in terms of the scale and the time and (indistinct).

10 We also had something change in terms of the revenue flows to the states. Before that all the states provided the same type of services, same type of taxes. There has been a historic exercise, both by the states and the Commonwealth, to normalise or equalise the revenue raising effort, the types of taxes, and the types of services. Because we interact at the state basis, the Commonwealth is involved, and also ministerial committees. So
15 we do a lot of the same things. Therefore, before the boom the variations in – from year to year over a short period of time – between fiscal capacity, didn't vary much at all. It was pretty steady. So the equalisation system, even though excessive in my eye, wasn't – didn't lead to very high distortions.

20 Then the boom came and we had a massive change in circumstances in one state, WA, where iron ore royalties went from – I can't remember exactly, about \$300 million to \$6 billion over a very short period of time. The production went from 120 million tons to over 800 million tons of iron ore. The differences between Western Australia and other states is largely
25 the iron ore story. A single commodity, single source of revenue. Most of the LNG, which was a heavy cost to us, the revenue flows entirely to (indistinct); it's an issue but - so we had, I think, revenue from iron ore peaked at \$6 billion in 2012/13, 13/14, something like that.

30 At the same time during that period, the pricing of iron ore changed fundamentally from long term contracts to spot market. First it went from a three year contract where it's very predictable, you knew what the price was three years in advance and it didn't vary. Then it - I think it shortened
35 to a one year contract. Then it went to spot market and varies 50 per cent within a year. Highly volatile, highly volatile revenue space. Probably more so than any other major revenue flow into a state, including I might add the stamp duty conveyancing. That varies quite a bit, but nothing like this. That's a transaction issue, not a pricing issue. So we had that.

40 We had a huge cost boom. Huge infrastructure both to the mining sector and oil sector, and population. Housing starts went from about 12 to 13,000 a year to 30,000 a year. So we had huge costs pressure on the state and the government. Prices were up, almost out of control in terms of
45 wages. I can remember 2006, Chip Goodyear, the head of BHP, stated that

he would build no more infrastructure or mines in Western Australia because if he builds another one, that adds more cost to all the existing ones. So we were at full capacity.

5 Then the Grants Commission continued as if this was just normal. Of course, it had a policy of equalising to the top, which was us, but we had the highest costs. Basically, if you're equalised to the top, what do you do? You bring the top down and backfill everybody else, that's – otherwise you can't – if you fill to the average it's – the average is across. If you average
10 to the top, you basically bring the top down and average it.

 So we were - eventually saw the - in terms of revenue flows before the boom, we got 25 per cent of our revenue on GST. Quite predictable. Some variation. About 4 per cent on all minerals. 16/17, we got 22 to 23 per cent
15 on iron ore and 7, 8 per cent on GST. So we shifted during that period. This is one issue is the volatility. We shifted from a stable source of income to a highly volatile – highly volatile, 50 per cent within a year, and unpredictable. It was also tied to the China boom, and who knows what's going to happen on that. Most of the people who are in the business of
20 predicting iron ore prices have given up because of the volatility.

 Then we had this cost pressure, and it was immense. No other state felt it. No other state experienced the cost pressure this state was under to provide - not just provide existing level services but to expand it for a 35 per
25 cent increase in population over a seven, eight year period.

 So we had the Grants Commission saw something that was abnormal. Instead of saying, "We have an aberration, let's treat it as something different", there are many ways to do it, they kept it as normal, and
30 basically, redistributed 90 per cent of this one-off revenue to other states with a lag of three years. They also have, as bureaucracy tend to be, particularly become all very data driven. That is they're very empirical, if they can't measure it, it doesn't happen. They also are very focussed on things across the nation, so if one state does it uniquely, it is basically an
35 equalised state.

 Then during that boom, we had a unique circumstance in Western Australian more generally, the other states, except certain places in Queensland, weren't experiencing. Give you an example, in most states,
40 wages outside the metro area are lower than the metro area. In Perth, particularly during that boom and still, they're double. The wages in the regions are actually probably more than double but let's say double, than Perth. So they decided that if it's regional development, wages are lower than the city. That's just ridiculous. It might fit Queensland or New South
45 Wales, but it was absurd for us.

Also they take, in terms of the cost measurement, if you can't measure it, it doesn't exist. That's all right, let's say for Gladstone which is going on incremental developments. It's been there for a long time as an industry city. But we had to go out and put \$300 million in Onslow that, before the boom, was a 600 person clapped out fishing camp.

MS CHESTER: Dr Nahan, I might just interject there, if I may, because you've had a chance to speak now for about 10 minutes.

DR NAHAN: I'm not done though.

MS CHESTER: And we are - - -

DR NAHAN: I need to emphasise this because the - - -

MS CHESTER: We allow participants five minutes introductory remarks and then we need to get into questions.

DR NAHAN: Okay.

MS CHESTER: And Jonathan and I would like to get into some questions with you, so maybe if you could just wrap up briefly and then we'll get into some questions.

DR NAHAN: Yes, yes. So there's a severe measurement problems with the Grants Commission. These were augmented by its decision to not – to equalise to the top, and that top was an aberration and it overestimated, because of its problem with costs, the amount that it could equalise and I might add also when it equalises at average. A couple of things, one is the dynamic efficiency effects which is over time equalise to the top, especially in the boom time economy like that, gives an incentive to the other states to not undertake the serious political decisions of extracting resources.

I know in your preliminary report you indicate that this is a possibility, but you did not measure it. It should be measured. It's been raised many times in many reports in the past. The dynamic efficiency effects are significant and obvious. What I think has to happen, the – because of this impact, the Grants Commission process led to, particularly with the lags in the GST adjustment and the simultaneously reduction in GST share from 70 to 30 per cent and the decline in iron ore revenue – which was a major source from \$600 million to 300, \$6 billion to \$3 billion – led to the state needing to borrow in the vicinity of \$8 billion. The cost of that borrowing is not taken into consideration of this. It was an adjustment effect. It was

an aberration and that imposed significant cost on Western Australia in the past.

5 My view is that we should, as our submission made, move to a per capita, but the – in the spirit of trying to come up a practical second order – second best solutions, our recommendation is, like you suggested, is to move to equalising to the average. But I would like to suggest a couple of alterations to it. One is that the territories, ACT and the Northern Territory, be taken out of the equalisation process and dealt with directly by the
10 Commonwealth in whatever means the Commonwealth wishes to deal with it. The reason for that is ACT, which is - by income has the highest average income of all the states and territories. Its problem is its major business, the Commonwealth, doesn't pay taxes. Therefore, the Commonwealth and its workers should directly compensate the ACT.

15 The Northern Territory's – which receives substantially in aggregate more GST than Western Australia for one-tenth of the population – its problem is not Darwin, which is quite a lucrative and wealthy city now, but Aboriginality. It's largely to deal with Aboriginality factor and the Grants
20 Commission process. Both of them are constitutionally the responsibility of the Commonwealth. So my suggestion, our suggestion, is that we take – we equalise to the average without the territories being in them at all, and that one of the biggest problems we have is in fact that this requires unanimity amongst the states and Commonwealth and therefore it's a zero
25 sum game, it's a (indistinct), a fixed pool, and that the - there has to be a substantial transitional arrangement. We recognise that.

If you equalise to the average and take the territories out of the equalisation process, the transitional arrangement is not as severe. There is
30 a scope, as other people have argued, for the Commonwealth to step into adjust this, particularly interim arrangement for Western Australia. But my argument will be - is that the interim payment should be used to reduce that \$8 billion debt that was built up because of the shocks of the GST and iron ore prices, and should be used to make a transition to ease Western
35 Australia's debt build up because of the shocks to the GST.

In summary, the issues – you need to look at the methodology pursued by the Grants Commission. Its aim is to strengthen Federation, but is actually weakening the Federation. Indeed, bringing the Federation to the
40 brink by failing to react to shocks to the system, and that equalisation to the top is impossible to sustain in the long term. Moving to the average will be a better thing and ameliorate the problems with it. But also, it will lead to a higher transitional arrangements cost and probably therefore no change is being undertaken by the political masters. Therefore, my suggestion is that
45 we eliminate the equalisation process to the territories.

5 **MS CHESTER:** So thank you for those remarks, and thank you for giving us an update on what your views on what the policy should be to deal with the world of outliers. Before we sort of get into changes to policy settings and transition paths and the like, I guess just two questions prompted by your remarks. The first one is around WA being an outlier with iron ore and the mining royalties. I think a lot of people refer to the mining boom as being over. I think it's perhaps best to say the construction boom is over, and the wonderful mining bedrock remains.

10 So one issue that's been put to us is if you look at the numbers 2000 to 2017, the outlier problem that highlighted the system struggling to deal with outliers really kicked off about 2006, 2007 in terms of the relativities. To what extent is the current outlier system, with WA having such a high fiscal capacity, the new norm or is it a blip?

15 **DR NAHAN:** Yes, it depends upon your assumptions about prices and quantity of iron ore. But I think if you assume that the \$50 or low 50s iron ore price is a long term, take the consensus forecast, 10 year consensus forecast, it is – there will be for as long as we – for that prediction holds, a very large outlier to Western Australia from iron ore.

MS CHESTER: Okay.

25 **DR NAHAN:** Exactly how much I can't say but this is – you're right, it was an investment boom that led to very, very high cost structures that were not adequately considered by the Grants Commission. It did produce a production boom that employed a hell of a lot less people, and that was a problem. But it will that - for as - on the given expectations by the experts, that high outlier in terms of revenue, WA will continue for the foreseeable future.

MS CHESTER: Okay.

35 **DR NAHAN:** And it will be unique to WA.

40 **MS CHESTER:** Okay. The other comment that you made earlier on in your opening remarks was about effectively suggesting that we should measure the counterfactual, so what would happen if other states were to undertake developmental activities that they're currently not. I'm not aware of a reliable methodology to do that and indeed the CGC itself and states and territories struggle to have an assessment of say what CSG base would reside below the surfaces of other state and territory jurisdictions is – how do you suggest we undertake that?

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DR NAHAN: The Grants Commission does a review every five years and there's a lot of data, and other places do it. One way is – which is in the public domain, is the treatment of gambling revenue. Now that's slightly different in that the - a theme of the Grants Commission is that it's policy neutral, that is that it doesn't try to determine the policies or dictate policy to the states, and that it is the policy of the states to leave resources in the ground or not. Then the statement is if you decide to peer through that policy decision, how do you measure it? You can't measure it precisely. We have a lot of uranium in this state but we don't export any because the price is low, so what's to value to that?

Others - we have now lot - we've - so – but there are - what the traditional way is to discount things. For instance, there has been a lot of suggestions in the Grants Commission because of the lack of precisions about measuring things about urban or regional development for example, about uncertainty, uncertain things. They give discounts, crude discounts of 25, 50 per cent from the cost of it. You're going to have to use those types of measures.

We're not arguing that the Grants Commission should be turned on its head and start getting involved in saying what's good policy and what's bad policy. We're not arguing so much for crude discounts like that. The way to solve it is not to equalise as thoroughly. Your interim report suggested that you move from the - equalise to the top to the second top or equal – that will diminish the disincentives quite a bit. Our argument is you know, and our submission is, that we should even go further than that and go mainly to equal per capita over a transitionary period with about 20 to 30 per cent of the GST pool equalised. The less you equalise, the less the distortion of the dynamic efficiency effects are.

MS CHESTER: Yes. I think that's part and parcel for the direction that we identified in our draft report. Will we be getting a submission from you outlining in more detail your position post our draft report in terms of moving away from, I think it was EPC 90 per cent and 10 per cent on full equalisation?

DR NAHAN: Yes.

MS CHESTER: Because it would be good for us to get a better understanding of the transition path that you've got in mind and how that can be funded.

DR NAHAN: Yes.

MS CHESTER: Are you able to share any insights on that today?

DR NAHAN: In our first one we didn't. We left the transitional arrangement up to you. We didn't explore it very – and it will be – the transitional arrangement is, to a large extent, the guts of the issue. Without
5 an adequate transitional arrangement, without your ideas on it, one would have to fear reforms, the – whether the reforms would be carried out.

We're not that interested in the Commonwealth just borrowing more money and placating the state for – WA, for a period of time. That's just a
10 sugar hit. It would help, particularly to defray that \$8 billion in debt we built up because of this transition arrangement, but then fundamental reform is needed. To look at the transition, you have to crank some numbers. For instance, what would be the magnitude of the adjustment once you took the territories out and moved to an average? To some extent we have, in
15 opposition, limited capacity to model that. We don't have Treasury access. You might be more able to do that so we could spell it out in terms of the objectives of that.

I would think a three to five year adjustment period. The Grants
20 Commission goes in five year cycles, both three and five year cycles. You would have to have that for a period of time, and you'd have to take – look at the numbers of it. The longer you stretched out the transitional arrangements, the longer Western Australia has to carry that \$8 billion burden which – the cost of which, \$350 to \$400 million a year in interest
25 costs, for a period of time. So the Commonwealth might want to put some assistance in there to carry – to assist WA during the transitional period. My argument would be any moneys should be used to reduce debt, not to – not tie into infrastructure as such.

MS CHESTER: Okay. So do you still stand by the principle, I think in
30 your pre-draft report submissions then that “For the transition period of several years”, and you've said “five”, “but no state experiences a year to year decline in actual GST receipts”?

DR NAHAN: Yes. I think the appropriate - - -

MS CHESTER: So keeping the other states and territories – well, keeping the states that remain within that system whole for the five years?

DR NAHAN: Yes.

MS CHESTER: And who would be funding that if you say that you don't want the Commonwealth Government to raise that?

DR NAHAN: My view is we should go up to that period. Western Australia's share will pick up. It will, unless we get another huge increase in iron ore prices, which no one's expecting. So the way you could do it is do a floating floor, that is as Western Australia grows its share goes up.
 5 Over a three to five year period, no other state is ex ante worse off. Now true, if iron ore prices don't meet as predicted, let's say the higher, other states might ex post be worse off.

10 So my suggestion and the way that no one's worse off, is have a floating floor for a five year period till Western – till the system gets back to something like that would be - with the territories excluded, something like an averaging to the – I'd say equalising to the average would achieve. These are empirical questions but I can't really measure it. Then go to the new system.

15 **MS CHESTER:** So over that five year period is – and I'm – so the floating floor is like - - -

20 **DR NAHAN:** It's three to – three to five year period.

MS CHESTER: Three to five year period, so that's moving to ETA. So if we were to do ETA tomorrow that takes WA to 87 cents, .87 of a relativity.

25 **DR NAHAN:** What's "ETA"?

MS CHESTER: Sorry, equalising to the average.

30 **DR NAHAN:** Okay, yes.

MS CHESTER: Forgive me. I've been living in the world of ETA a little bit longer than others.

35 **DR NAHAN:** Okay, yes.

MS CHESTER: So looking at the – that transition path if we were to keep the other states whole, we are looking in the order of magnitude of billions of dollars, if you don't want – I'm just trying to work out who's going to be funding that if you didn't - - -

40 **DR NAHAN:** Well if you - - -

MS CHESTER: Given your earlier statement that you didn't want the Commonwealth Government borrowing to do that.

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DR NAHAN: Yes. First of all, you'd take the – if you take the territories out and the Commonwealth funds those, the transitional arrangement, the equalisation is much less to the states, to the residual states. We've done some numbers in the past and it reduces - taking the territories out, particularly the Northern Territory, which is in the vicinity of \$2 billion and you put them together at about \$2.5 billion, that reduces substantially the redistribution in the pool, residual pool. As Western Australian moves up over the next three to four years towards 70, which is what I believe it's going to do, if you take a three to four year period you allow WA to go back towards the 70 and you take the territories out, I think if you crank the numbers you see the compensation external to the states is greatly reduced.

MS CHESTER: I think we can agree it's reduced, but even hundreds of millions to Queensland alone would be required, given their starting point of I think 1.12 or something.

DR NAHAN: Yes.

MS CHESTER: So you see the Federal Government funding that but not borrowing.

DR NAHAN: No.

MS CHESTER: So how would they fund it?

DR NAHAN: Well, I'm not sure. You'd have to look at the numbers. If you take the territories out which as – and I don't think you've done yet, in your measure - modelling.

MR COPPEL: No.

MS CHESTER: No. No, no, we've not recommended that.

DR NAHAN: Okay. You take the territories out and you go for a four year, let's say, period, because I've never looked beyond four for forward estimates, Western Australia goes up towards 70 per cent, under the existing model with the territories in. If you took the territories out, we would push towards 80 per cent, I would think. You would see that the adjustment period is not large relative to where you would, under the existing model. Then you make some adjustments and - - -

MS CHESTER: So but if we're taking the territories out, who's then paying – so - - -

DR NAHAN: Territories, it's Commonwealth.

5 **MS CHESTER:** Yes, so – okay. So effectively the Commonwealth is really paying for the transition path. You’re taking the territories out, they’ve got to pay for that. They’ve paying for those that stay within. So the Commonwealth is picking up the tab for everything.

10 **DR NAHAN:** No, the Commonwealth is not picking up the tab for the states. The Commonwealth is picking up the tab for the territories which are Commonwealth – constitutionally Commonwealth entities. They do have self-governance but that’s bestowed on them by the Commonwealth.

MS CHESTER: Okay.

15 **DR NAHAN:** So you – the – you take the territories out and you give them back to the Commonwealth and you - then the - your pool is not changed. But the equalisation process across the states is greatly diminished and you allow Western Australia to go back up towards 80. I think, if you model that, you will find the impact on individual states is not huge. There will be some. But the – that - in my view is that that has to be borne from within
20 the states, not the Commonwealth.

MS CHESTER: After the transition period?

25 **DR NAHAN:** Yes.

MS CHESTER: But during the transition period, the Commonwealth’s picking up the tabs for the states?

30 **DR NAHAN:** No.

MS CHESTER: Keeping them whole?

35 **DR NAHAN:** No, no. The Commonwealth takes on responsibilities for its entities, the territories. Okay?

MS CHESTER: Sorry. So I thought your pre-draft report submission said that “The transition period would be such that no state experiences a year to year decline in actual GST receipts”.

40 **DR NAHAN:** Yes.

MS CHESTER: And the Commonwealth would pick up the tab for that transition period.

DR NAHAN: No. That was moving to a per capita. I've said I'd gone to a second best to accommodate your – so the - - -

MS CHESTER: Okay.

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DR NAHAN: We had moved. We still think per capita, but we have moved and responded to your draft report and the response to it was quite positive to move to an averaging from the top to the average. Our view is if you move to even - the compensation even moving to that would be
10 excessive. So the argument we have is you bring the territories out. That we move 2.5 and therefore - 2.5 billion from the pool, over a three to five year period as Western Australia's share adjusts, you hold it there, during that period ex ante there should be no need for compensating the states. There's a need to compensate the territory and not the states. There is an
15 adjustment period. Then when you get to a stable 80 per cent, I would think, then you go to averaging per capita.

MS CHESTER: Okay. So you're saying by taking the territories – so I think I may have connected the dots now. Sorry, it's taken me a little while.
20 So by taking the 2.5 billion out with Northern – out of the GST pool of the Northern Territory and the ACT, the 2.5 billion that the Commonwealth is now funding separately, would keep the other states whole during the transition period?

25 **DR NAHAN:** Yes. Largely, yes.

MS CHESTER: Okay. So how is the Commonwealth Government going to fund that if they're not going to raise debt?

30 **DR NAHAN:** Well, it's their workforce that they're not paying the payroll tax, stamp duty, land tax, and other things on. So my argument for the ACT is that it's just a – it's like Newman, who pays all the royalties and – for Newman is a mining town up north. The mining firms pay for that. The ACT is largely a home base for the Commonwealth and they should – which
35 has the highest average income of any city. The Commonwealth should carry that. So the Commonwealth carries the responsibilities, as they should, for the territories. Just like they do for - - -

40 **MS CHESTER:** So a payroll tax for the territories?

DR NAHAN: Well they can – how they fund it - - -

MS CHESTER: I'm just trying to work out what funding mechanism you have in mind, if you didn't want to - - -

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DR NAHAN: That's for them to decide. They can equal out – they can come up with a – they can encourage the territories to levy additional taxes which they don't levy now or they can pay it out of their own source income or whatever.

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MR COPPEL: Just shifting gear, in your opening remarks you said that the process and the extent of HFE are fundamentally flawed, and we've spoken a bit about what you see as the solution to the extent issue. What do you have in mind in terms of how to address the fundamental flaw, what you characterise as the fundamental flaw in the process?

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DR NAHAN: Well, the best way that – you cannot get perfection in this system. If you tried to equalise with perfection, you come in – especially if you're empirically driven like you - like they have to be, and the lack of data and lack of comparison. So there's a couple of – perfection's not possible, particularly in this - in their task. Data is not equally available and there aren't uniformities about approaches. Once you go achieve to, equalise to top, the flaws get worse. So one way is diminish the extent and thoroughness of equalisation. If you look around the world, that's what most Federations have decided to do, they diminish equalisation over time. Okay. There is other forces at work, like politics, that tend to do that too.

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So your proposal - our proposal would move to diminish equal – Horizontal Fiscal Equalisation as the priority and move to equal per capita. That's our priority. Your proposal, which we're – in the interests of a reform the - we'll support, is diminishing to the average, which I actually thought 20 years ago was the policy, to be honest. I might be wrong on that. But when I looked at Grants Commission in the early 90s, they often equalise to an average for some levels, but nonetheless. So once you diminish the extent of equalisation, your targeted equalisation, the distortions diminish.

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I actually think that the boom was a construction boom, but that's where the pressure was, has eased and therefore the distortions, the data distortions that the Grants Commission used that underestimated our cost, should not re-appear right away. That was a one-off blip, hopefully.

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But another issue is that the Grants Commission, I think, needs to be wary of perturbations in the system, shocks to the system. This should've been identified earlier on where the norm no longer fit. The Grants Commission, as a bureaucracy, failed to respond. They could've responded in many ways. They did respond a little bit when the – and the governments responded when they changed the treatment of iron ore fines. They kind of rolled that over for a couple of years. That was an illustration that the system didn't sit very well and there was problems. Clearly there was

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because what happened was iron ore fines that in the market was discounted, discount was taken away and we adjusted.

5 So simply, reduce the extent of equalisation reduces the extent of the distortions greatly. We would say reduce it even more, but the average would help quite a bit, and also the boom passing will help quite a bit. But I think there needs to be a consciousness on the Grants Commission to be observant, to be wary of shocks to the system and they could exist in the future. If every state is providing the same level of, more or less, service and same types of tax, almost the same tax rate, the equalisation process is not too bad in terms of distortionary effect. But when you get a shock, like we clearly went through, it doesn't fit. It doesn't work and it brings the Federation to the brink.

15 **MS CHESTER:** A couple of other things that would be helpful for us in finalising our thinking and looking for the evidence base that we need for our final report, any examples that you can point us to of where the current HFE arrangements have either precluded a development activity from occurring in WA or have distorted a royalty policy or a potential state revenue reform?

20 **DR NAHAN:** Not in recent times. They used to do it in Queensland, but that's history with the pricing of Rio facilities. That's an old story. In WA, honestly, we have had bipartisan pro-development governments. There is a – both an efficiency effect and an income effect. Okay. I struggle in Western Australia to identify an efficiency effect, but income effects I would. Firstly, if Browns Range came on now, which is a large potential project up in the north, and it would require hundreds of millions of dollars' worth of state expenditure, which it would, infrastructure, Aboriginal claim settlements, you name it, the state is not in a fiscal position to undertake that. It just isn't. It might bend over backwards for a high level spec to do it, but it would struggle.

35 If Onslow, for instance, let's say Chevron found another resource that unexpected, like Wheatstone, and the - they and us had to spend the billion dollars in onshore social infrastructure, we'd struggle, unless the Commonwealth came in. So there's an income effect because of the debt. I would argue that that same thing happened in Tasmania repeatedly when they decided to not build a pulp mill, or reduce access to their major resource was logging, or inhibit the development of mining. The - it wasn't 40 – they knew – they didn't do that on the basis of the efficiency effect. They knew they would get partially compensated for their decisions to lock resources away through the Grants Commission process.

- At times during the 90s it was a Greens Coalition with the Labor Party and, I think you can find in Hansard, the Greens were particularly aware of that, whereas the Labour Party wanted resource development and I think their Green Coalition partners didn't. So you can see that it's not so much that people decide specifically to – at the margins, but the income effect is quite clear and obvious. Even though New South Wales and Victoria are donor states and will - always have been and always, for the foreseeable future, remain, they know that at the margin they are being compensated from Western Australia for locking gas into the ground.
- MS CHESTER:** Okay. I'm very conscious of your time and we do have one more participant to hear from. Is there a time frame in which we might expect to receive your post-draft report submission?
- DR NAHAN:** Yes. I would like - what - I do two things. I will send you the scheme of it so maybe you can model it, if you have greater access to modelling resources than we do, because I think you have to optimise this by saying make these assumptions, see how the estimates flow out to see if the degree of compensation is needed.
- MS CHESTER:** Well, I suspect on the forecasting of relativities and impacts, WA sort of is leading the pack at the moment, the WA Government. So you might ask for help from - - -
- DR NAHAN:** I'm not in government any more.
- MS CHESTER:** I know.
- DR NAHAN:** Yes.
- MS CHESTER:** But you could still ask them given I - - -
- DR NAHAN:** Yes.
- MS CHESTER:** We've been told by parties that reforming HFE is an area where you've all come together. But by all means, once we fully understand - - -
- DR NAHAN:** If that's the case, then I would probably – if in fact your statement is true and I can get the cooperation of Treasury, State Treasury, then I will - - -
- MS CHESTER:** I suggest it might be worth trying.
- DR NAHAN:** Okay.

5 **MS CHESTER:** Okay. I might be wrong in saying so, but based on earlier comments today. Then the formal submission in a week or so, could we - -

10 **DR NAHAN:** A couple of weeks, yes.

15 **MS CHESTER:** Okay. All right. Did you have any questions? Okay. All right. Well, look thank you very much for appearing this morning.

20 **DR NAHAN:** Okay, thanks.

25 **MS CHESTER:** We appreciate you making the time. I'm sure you, like others, will look forward to reading our final report early next year.

30 **DR NAHAN:** Yes. Okay, thanks.

35 **MS CHESTER:** Thank you.

40 **MR COPPEL:** Thank you.

45 **MS CHESTER:** Okay, folks. We just have one more interested party who'd like to be heard today. So if you'd like to just state your name for the purpose of the transcript record and then if you could talk for five minutes, then give us five minutes to ask any questions of you, that'd be great.

MR DAVIES: Yes, yes. Mr name is Eric Davies. I'm a - - -

MS CHESTER: Sorry. Excuse me. Guys, can we please have quiet. Thank you. Yes?

MR DAVIES: My name is Eric Davies and I'm a private citizen, but I represent a group of – and it's at this stage, an informal group of people who are looking at the politics involved in the GST situation. Sitting here through all these proceedings, I get a sense that you, the Commissioner, you don't really understand the sense of anger in Western Australia, the depth of anger in Western Australia over the GST carve up. It is palpable.

That has severe political implications for the situation going forward, because I get a sense that you people are going to have to go to other states and justify various positions that you might be wanting to take. There was - an example is this morning we've been – the proposal that resources royalties be discounted by 50 per cent and that equalisation goes to average rather than second or highest. I get a sense that it would be very difficult to

sell that in other states, especially the recipient states and territories. I would like to make the point that the anger in Western Australia is such that it could bring a lot of political pain to the Commonwealth Government.

5 We heard yesterday from some political types who – WA First Party, where they were proposing some kind of political action. I have to tell you that what our group has got in mind is way more powerful than that. That is insipid compared to what we've got in mind. The advent of social media makes it possible for a group like ours to contact West Australians and
10 present a very powerful political case. We believe that we would be quite capable of making Australia un-governable if we don't get a fair deal. I would like to make you aware of the fact that that is on the cards and that you might be able to use that when you're receiving submissions from – at other states. You might be able to use that to, maybe, ameliorate their
15 demands.

 There's a few other points that I'd like to mention very quickly, that the Commonwealth Grants Commission discounts income from other states for
20 poker machine revenue. As you probably know there are no poker machines in Western Australia. Now it's been said that the Commonwealth Grants Commission doesn't want to influence policy. By discounting the income from poker machines in the other states, what they're doing is saying to Western Australia that, "Because you don't want to penalise your
25 vulnerable citizens in the way that they've been penalised in the other states, we are going to take revenue from you because of that". In my opinion, that is a policy direction from the Commonwealth Grants Commission. That's one point.

 You said earlier on also this morning, that you thought that resources,
30 natural resources was a windfall from - the states have got from somewhere or other and you weren't sure whether that – whether they were the actual property of the state or the property of the whole of Australia. I have to tell you that it is the case that Western Australia joined the Federation on the understanding that the mineral resources of the state belonged to the state,
35 to the people of Western Australia, not to the whole of Australia, and that's written into the Constitution. So to say that that it is a windfall and that all of Australia should share in it, is not accurate. That sums up the basis of what I wanted to say.

40 **MS CHESTER:** Okay. Thanks very much, Mr Davies. I think one of our toughest challenges with the role that we have at the Productivity Commission is when we are recommending change where they'll be winners and losers, one of the advantages that we do have, as an independent statutory agency is, and indeed under our legislation, that we

try to view things through the lens of the economic wellbeing of all Australians.

5 So while we've talked this morning about the transition path being quite difficult because the GST pool is a zero sum game, that said we're very minded to try to be able to point out to other states and territories what economic benefits they are - there are for them in, perhaps, changing the current HFE arrangements in terms of the incentives that they face, to develop their own activities and resources and indeed to have a better reform revenue basis for their economies.

15 On the issue of the gambling, and this might ease some of your concerns there, the way the Commonwealth Grants Commission treats gambling revenue is to take it out of the equation when they're assessing the GST relativities. So it's not that WA gets penalised by getting less GST revenue, rather you don't get equalised to you some of the revenues that other states and territories raise through - - -

20 **MR DAVIES:** The bottom line is that Western Australia gets less cash because of that.

MS CHESTER: So you don't benefit from the revenues on pokie machines in other states and territories, that's right, because they take it out.

25 **MR DAVIES:** Yes. So the bottom line is what I said, we get less revenue because of that.

30 **MS CHESTER:** Yes. That's right. I thought you were arguing that you get money taken off you. So you're right, the net effect is I - I guess maybe I've construed too much into your comments that you think not having gambling taxes is a good thing and thus you wouldn't want the people from WA to benefit from that form of tax.

35 **MR DAVIES:** Yes. It wouldn't be a benefit, as I alluded, yes. Yes.

MS CHESTER: But you are happy to get the revenue that other states raise from gambling?

40 **MR DAVIES:** Well, it - because it's taxed revenue, it's taxed income.

MS CHESTER: Okay.

MR DAVIES: Yes. The point that I am making - - -

5 **MS CHESTER:** If you're happy with that being a form of revenue, then wouldn't it then make sense for the WA Government – so if you're not worried about getting revenue from gambling, then wouldn't you then have the position that the WA Government should use that as a source of revenue?

10 **MR DAVIES:** No. What I'm saying is that by taking that policy, by basically taking cash off Western Australia because we don't have poker machines, because most of that gambling income is from poker machines - taking cash off Western Australia because we – specifically because we don't have poker machines is equivalent to policy direction, in my opinion.

15 **MR COPPEL:** But that's not how it works. Cash isn't taken out of Western Australia because they don't have poker machines. The whole thing's - - -

20 **MR DAVIES:** Well, cash – the – well, you've just agreed that Western Australia gets less cash because we don't have poker machines or because of the policy.

MS CHESTER: Because they've decided to take it out of the equation.

25 **MR DAVIES:** Correct. They've taken it out of the equation. It's still income of the other states. If it was put into the equation, then Western Australia would get more cash.

MS CHESTER: Okay.

30 **MR DAVIES:** Yes.

MS CHESTER: But you don't want to have revenue on pokie machines in WA?

35 **MR DAVIES:** No. The point that I am making, I – the point that I'm making is that by doing that it is a policy direction. It is influencing policy, because it is a policy whether or not we have poker machines. That is a matter of policy.

40 **MS CHESTER:** But it's a policy decision of the WA Government not to.

MR DAVIES: Yes, correct.

45 **MS CHESTER:** So CGC's guided by wanting to have policy neutrality. WA's chosen not to have policy neutrality. They've made a decision not to tax pokie machines.

MR DAVIES: Yes. Not to have poker machines.

MS CHESTER: Yes.

5

MR DAVIES: Yes, yes.

MS CHESTER: Okay. Great.

10 **MR COPPEL:** You make the point, which I think we agree with, that the transition is a very big challenge.

MR DAVIES: Yes.

15 **MR COPPEL:** And that we've got an onus on us to demonstrate the benefits to the Australia community of a change. But in a system like we have, which is a zero sum game, it's very difficult to move away in jurisdictions that have a relativity above one. I think you were here yesterday and I made a point that that incentive is always there, but it shifts
20 from jurisdiction to jurisdiction, depending where those relativities are.

There was an episode in the early 1990s where there was an opportunity to shift to a different system and one of the jurisdictions that was against that was WA at the time, because it had a relativity above one. Now I don't
25 do that to point the finger at WA. It just underscores that that is the challenge that we face and we have to demonstrate that moving to a different system has benefits that go beyond what is lost, in terms of the impact of that on the GST distribution. I just wanted to make that point, because it's not something that is new. It's always been there and it's the
30 way that jurisdictions will argue.

MR DAVIES: Yes.

35 **MS CHESTER:** Well, Mr Davies, we thank you for raising your hand and wanting to be heard here. It is part of the reason we have public hearings and we do canter around Australia, is that we don't only want to hear from government departments and politicians, we also want to hear from the people of the states and territories. I think you've tried to convey some of the sense of the feeling that WA people have towards the current HFE
40 arrangements and we thank you for that.

MR DAVIES: Okay, thank you.

45 **MR COPPEL:** Thank you.

MS CHESTER: Thank you. Terrific, on that note, I call our Perth hearings to a close and we will luckily, I think, resume this Friday in Melbourne. So thank you all for attending and we'll wrap it up there. Thank you.

5 **MATTER ADJOURNED AT 11.48 AM
UNTIL FRIDAY, 17 NOVEMBER 2017**